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TITLE OF THESIS

**WRONGFUL TRADING AND THE
STANDARD OF SKILL AND CARE FOR
CORPORATE DIRECTORS: A
COMPARATIVE STUDY OF CORPORATE
GOVERNANCE**

Vol I

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ph D

GLAMORGAN

1998

Forward

This thesis was the product of some very focused and detailed research. It would not have been possible without the support of my two supervisors, Professor Margaret Griffiths, University of Glamorgan and Mr. Howard Johnson, University of Wales, Cardiff, for whose diligence and support I am truly grateful.

I would also like to thank my family and friends for their support throughout the production of this thesis.

For Joshua

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FORWARD

This thesis was written during the Conservative administration of 1992-1997, and reference to the Government unless otherwise stated, refers to that Government's administration.

The importance of declaring this, is to discern the difference in attitude from the current administration on issues such as worker representation on corporate boards, the issue of corporate regulation in the City and the involvement of shareholders in management.

All of these areas may yet prove not to have any discernible difference in attitude or policy, as pressures from the different groups within the corporate nexus, exert themselves, in persuading any government to protect their interests as a priority.

CHAPTER 1

INTRODUCTION

The advent of popular capitalism has initiated many debates surrounding the role of the corporations and their officers both in the UK and the international community. In particular, the relationship of the director with his shareholders, creditors, employees and the broader community have been subject to greater scrutiny. This has developed the concept of the “director corporation” and redefined their role and objective in relating to all the nexus groups within and without the corporation. The objective of each nexus group will invariably differ and even involve conflict with others in the same corporate entity. The role of the law in formulating new standards of directors’ duties and creating general objectives for the corporation is to seek to balance all interests within the corporate nexus.

Insolvency law in England and Wales has been harnessed to achieve some progress in raising standards of director behaviour. With its unique evolution English insolvency law is seen not just as an efficient means of liquidating company assets. It is also a basis for providing the commercial world with legal devices which ‘punish’ those in that community who fall short of the standard of care demanded by the ever broadening shareholder base. The position is clarified by Peter Totty, a partner in Allen & Overy who, commenting on the Insolvency Service stated :

“Insolvency law ... underpins all commercial law.”¹

In the far reaching legislative reform programmes illustrated in the Companies Acts 1985, 1989 the Insolvency Acts 1986, 1994, The Company Directors Disqualification Act 1986 and

¹ “Promised Land for Debtors” The Times. December 2nd 1993

the Royal Commission Report which led to the Acts² the importance of policing directors and of developing their duties becomes increasingly apparent.

The objective of this thesis is to analyse and explain the reasons for the particular development of section 214 IA 1986 and the broadening of its remit in the area of governance. In this respect I shall attempt to place in perspective its ability to act as a policing measure against the misconduct of directors in a society which is increasingly characterised by mass incorporation of business and the establishment of an entrepreneurial ethos.

In analysing the role of the Insolvency Act and related legislation in affecting the development of directors duties, there is a need to consider the reaction of society to insolvency, and whether this is reflected consistently in the provisions of insolvency law. In particular the effects which the legislation has relation to personal liability in this area of insolvency and its inception as the vanguard of commercial morality will be viewed and the problems that have been encountered on its application in the courts.

The importance of corporate law as an expression of the values which society deems acceptable in the process of making profit underpins the idea that the area cannot be viewed in the abstract but rather as an expression of the close relationship between the company and society. Corporate law not only affects the individual, in that the individual is a shareholder or creditor of the company but also indicates the aspirations of society towards profit and the accepted methods of achieving that profit³. This factor has magnified in importance as the number of people in society who are affected directly or indirectly by management decisions in large listed corporations continues to grow.

² Insolvency Law and Practice - Report of the Review Committee (The Cork Report) (Cmnd 8558) 1982 chaired by Sir Kenneth Cork.

³ Parkinson : Corporate Power and Responsibility, Chapter One.Oxford Clarendon Press.1993.

In this context, the growth in the expectations of the director will also be considered. The common law standard of care illustrated in the case of *Re Equitable Fire Insurance Co. Ltd.*⁴, has been superseded by statutory development⁵. However, the capability of this statutory response can be measured only by its grasp of the growth in power of the director in the context of him receiving greater autonomy from the articles of association, and from the incapability of the shareholder to act as an effective check on the directors powers.

The recent development of English company law has a tradition of being conscious of the new parameters and controls of its foreign competitors. The effectiveness of commerce to remain competitive is an integral part of the regulations which affect our corporations. It is therefore appropriate that the approach of European competitors and other advanced trading nations are analysed to see if their proposals and laws relating to directors' duties are more effective as a policing measure generally, and more sensitive to the changes in the economic and power structures of the company. Important here is judging whether their developments are sensitive to the needs of the corporate form which in fact, if not in law is a very eclectic institution covering many differing economic areas, different sizes and resources.

Remedial action in Britain to weaknesses within the corporate structure can only be attained once those weaknesses are identified. Such weaknesses were illustrated in the developments of the *Queen Moat Hotels Co.*⁶ The case indicated the weaknesses of the law to ensure that, as the company grows, and thus has the capacity to incur increasing amounts of debt, there are sufficient restrictions on the company to ensure that any such debts are protected and that this can be effectively achieved by independent observation of the company, and in particular Board activity.

⁴ [1925] Ch 407 (Chancery Division). See post Chapter 7.

⁵ In particular Section 214 Insolvency Act 1986. See Chapter 2 & 3.

⁶ See post Chapter 7. The weaknesses illustrated in the structure of the company were reviewed inter alia, Patrick Weever "QMH: anatomy of the crash" *The Telegraph* 27 February 1994.

Connected with the perceived weakness of the current corporate structure is the objective of ensuring that the directors employ effective measures of communicating with others in the corporate nexus who will make an important contribution to company policy. In achieving this the directors ensure that the company distribute the correct information about its performance to the shareholders, auditors, creditors and even employees.

A new ethos of professionalism amongst the personnel of companies has to be established as an indication that directors and others understand the gravity of their position as trustees of often large amounts of money belonging to the small investors, and of the importance attached by society to the privilege afforded to the company in the form of limited liability. In particular, the role of the institutional investors who act on behalf of the general public in the form of pension funds and savings plans will be analysed to assess what factors determine the effectiveness of their monitoring, and indeed if the law goes far enough in requiring them to participate actively in the policing of directors.

The Insolvency Service plays an important role in ensuring the effectiveness of the law's application in the area of director policing and in ensuring objective standards of corporate management. Its structure, and ability, is central to the success of commercial policing, so this thesis will look at the current performance of the service and suggest reforms which will meet the needs of the commercial community. The ambit of this service is considerable both as an administrator of insolvency winding-up procedure, and as a protector of commercial morals.

Despite the rapid problems caused by the growth of small business ventures and the on-set of the last recession, the service has been required to keep the same standards of vigilance over the commercial community. This undoubtedly affects the service's ability to keep control of the delinquent actions of many corporate directors as financial constraints preclude effective action based on an already controversial area of law⁷.

⁷ See post Chapter 6.

Introduction

As an integral appreciation of the effectiveness of the service in achieving its aims, it will be essential to view the commercial community's attitude to the service, and the Government response to the increased pressures with which the service is now confronted.

The growth in public subscription has led to greater interest in the activities of the directors and officers of the large public companies. The effect this has had on the general expectation of the director indicates that there is an ever increasing danger of an expectation gap between the public's perception of what is acceptable behaviour for the director and his liabilities and responsibilities in law and in practice. Indeed the interpretation of the court of those measures designed to prevent malpractice, can be seen as compromising standards of behaviour which the public would wish to see maintained by the director.

To illustrate the difficulty in the relationship between the law and the insolvency service, it is appropriate to analyse the concept and ramifications of wrongful trading, and how it has been interpreted and applied by the judiciary. This analysis is placed in a political context, which illustrates a more general attitude to governance, from Government and society.

The debate concerning the effectiveness of the insolvency provisions as an integral part of the broader question of governance, can be further understood, by appreciating those characteristics within the UK which sets the question of governance apart from other European countries whose history and economic structures have led to a metamorphosis in the expectations of the corporation from profit maker to good citizen, broadening the corporation's objectives. For this reason, the German and French systems of corporate structure will be assessed, as will the general objectives of the European and international community on the part played by the different nations in ensuring effective governance without intimidating the enterprise spirit.

Finally, it is important to measure the expectation of directors towards their future role in the corporation. Here, the advent of creating greater legal standards for the directors will involve

training and an appreciation that the skills of the director will be assessed in part by the size of the corporation he governs and the expectation of those for whom he is acting.

In this respect the role of the director mirroring the role of the corporation will be subjective, yet this will be within the remit of an objective standard. To clarify the position for the director it will be advocated that an increase in the different types of corporation in law will reflect the various types of corporations which in fact, if not in law, exist. The result will be an incremental development of the corporation defined by statute which will refine both the judiciary's interpretation of what constitutes a director's duties and those non-statutory regulations which have increased in importance in post war company law.

CHAPTER 2

THE PHILOSOPHICAL DEVELOPMENT OF MODERN INSOLVENCY LAW

The pragmatic development of English insolvency law, has created a multiplicity of objectives which are now encapsulated in two major legislative provisions, the Insolvency Act 1986 together with the Company Directors Disqualification Act 1986 and the Financial Services Act 1986. These Acts have initiated new concepts to try and eliminate the flagrant abuse of limited liability, and to recognise that the role of the director is now far beyond that of trustee for the company, and that the practical application of the modern director's powers and responsibilities have lead to the creation of a 'managerial autonomy'. These Acts illustrate the pervading underlying philosophy of English insolvency law, which was summed up in The Cork Report (Cmnd 8558), 1982 :

*"Insolvency law, is treated by the trading community as an important instrument in the process of debt recovery, the threat or imminence of insolvency proceedings as a weapon for persuading a defaulting debtor to pay or make proposals for the settlement of a debt cannot be underestimated as it institutes in the majority of cases, the sanction of last resort for the enforcement of obligation."*¹

Insolvency laws, through their investigative processes, are the means by which the demands of commercial morality are met; any disciplinary measures against the debtor which may appear necessary in the light of this investigation process can be imposed either inside the insolvency proceedings themselves, or outside for example, by the machinery of the criminal law or by professional disciplinary bodies².

¹ Insolvency Law and Practice - Report of the Review Committee. Cmnd 8558, Chapter 4, para 235 (a) and (b).

² Ibid.

The Philosophical Development of Modern Insolvency Law

The emphasis on insolvency law and procedure as a means of establishing a code of practice for company directors, gives English insolvency law the peculiar idiosyncrasy of creating standards for corporate governance, at a time when the company is facing possible extinction, through the use of the Administration Order, or more likely through liquidation.

The need for the reforms, set out in the two Acts, stems from the fact that before their initiation, insolvency in England and Wales was dealt with by a,

*"Plurality of statutes and statutory instruments of widely varying vintages, with the relevant case law in a similarly fragmented and chaotic state."*³

One of the major problems with the law as it existed, was its lack of any firm principles to which the courts could be faithful. The law progressed in a piecemeal fashion, which by the mid twentieth century no longer provided a satisfactory solution to many of the problems inherent in insolvency proceedings⁴.

In particular, the problem arose concerning voluntary liquidation. Often, the liquidator would be a "director's friend" who would not be vigilant in his search for evidence relating to corporate mismanagement. The net result of this apathy would be to create a climate in which the insolvency procedure was used to sequester assets from company funds, leaving the company "dry", and the directors, with sufficient assets to create another company, of almost identical staff and assets but without the debts of the previous company; the notorious and well documented "phoenix syndrome"⁵.

³ Fletcher : 'The Genesis of Modern Insolvency Law - An Odyssey of Law Reform' [1987], *Journal of Business Law* 365.

⁴ Ibid .

⁵ This was made unlawful by S 216 and 217 Insolvency Act 1986. The sections prohibit the re-use of the company name and make directors personally liable for the debts of the company in contravention of S 216. Directors are also prohibited from using their spouses as a facade to continue trading de facto when they have been disqualified, or their corporation wound-up. See post.

The Road to Reform

The onset of the 1960's brought with it an increased number of these unacceptable arrangements relating to company insolvency, and with it came an increase in the political weight behind the whole concept of insolvency law. The maxim that insolvency had "no votes in it" ⁶ was overreached by a desire to take insolvency out of the "secret garden" ⁷ of the privileged few and reform it in such a way as to create a whole new ethos of insolvency legislation for both individual and corporate insolvencies⁸. It seemed that the pragmatic approach of English law to change the status quo was about to be usurped by an expeditious attempt to combat these "unacceptable facets of capitalism"⁹.

However, The Law Commission was denied the same sort of access to the legislative reforms, which were so prevalent in the corresponding Scottish law review which was published in 1982. The Department of Trade and Industry maintained their almost custodial claim to the area of insolvency which fettered the workings of the Commission. It was the accession to the European Community in January 1973 which acted as a catalyst to the overdue reforms. The Community required greater weaponry in its battle against cross border insolvency which was an increasing problem.

The Advisory Committee which was initiated to deal with tackling the British position was The Cork Committee, headed by Sir Kenneth Cork. Two Reports were to follow from the committee, between 1977 and 1982. While the committee had serious doubts about adopting the EEC Convention on the subject, its Report in 1977 did conclude with the recommendation that if the Convention were adopted, it would prompt an entire review of the existing insolvency law. Thus in order to be an effective force in moulding the Convention it would be

⁶ Supra 3.

⁷ *ibid.*

⁸ *ibid.*

⁹ *ibid.*

necessary to properly review our own law. This would provide the negotiators, with a conviction that would earn respect in the Community.

The net result of the Cork's findings, was the Insolvency Act of 1976, which was initiated by the then Labour Government, after the committee had made a preliminary report to the Secretary of State for Trade, Peter Shore. The Act initiated some minor reforms of corporate insolvency, but there was still much room for further regulation, and another more detailed report was to follow in 1982.

Cork and the 1986 Legislation

The objective of the Insolvency Act 1976, was to provide an interim measure to alleviate some of the more blatant shortcomings of the existing law. The bill was carried uncontroversially through Parliament, but it was left to Peter Shore's successor, Edmund Dell, to announce that a fundamental and exhaustive reappraisal of all aspects of the insolvency laws of England and Wales, would be carried out¹⁰.

After deliberation and debate which took much longer than originally intended, the report was finally completed in 1982¹¹. Criticism of the committee came from those who felt that a broader input from individuals outside the narrow world of insolvency, would provide more radical and far reaching legislation, sensitive to the growing public concerns of insolvency as an effective deterrent against director abuse of the corporation. Also there was a lack of empirical research upon which the recommendations could have been made, and the presentation was considered "sprawling and formless"¹².

¹⁰ Hansard H.C, Vol. 918, October 1976, written answer no. 20.

¹¹ Insolvency Law and Practice, Cmnd 8558, June 1982.

¹² Supra 3.

In spite of these criticisms, the report illustrated and codified some of the major aspirations of insolvency, which for many years had to be gleaned from observing limited and piecemeal reforms. It proposed the rationalisation, harmonisation, and modernising of the existing laws, and attempted to meet the demands of the public by initiating concepts which would it hoped fulfil its role as a policing body for director activity.

The Cork Report was published in June 1982 to a rather more phlegmatic response than that of its predecessor. The Government was indifferent and no debate was arranged in Parliament on its findings. It looked as though the former political apathy in the area of insolvency was once again to emerge.

However, the Conservative Government became increasingly aware of the public's lack of confidence which increased during the years of recession (1981 to 1983). An increase in liquidations coupled with major scandals both in The City and at Lloyds, prompted the laissez-faire attitude of the Government to modify and intervene. The growth of privatisation and consumer shareholders also contributed to the change in attitude.

The Cork Report was consulted and a White Paper¹³ issued in February 1984. The paper revealed that the Government would be adopting some but not all of the Reports recommendations. In particular, the White Paper emphasised the importance of applying more stringent standards to the conduct of company directors, through extending the parameters for directors to incur personal liability for company debts, coupled with disqualification.

The Cork Report suggested that there should be mandatory disqualification for serious misconduct with the court's discretion limited to prescribing the number of years which that disqualification would last¹⁴. The Government's response was initially even more stringent.¹⁵ It stated in the paper that if a director's conduct was *ipso facto* unfit to control the company,

¹³ A Revised Framework for Insolvency Law, Cmnd 9175.

¹⁴ Supra 11, para 1816 - 1837.

¹⁵ Supra 11, para 13 - 14, 46 - 51 and 53 - 56.

then he would be subject to an automatic three year order for disqualification, where the company was being wound up, because it was insolvent. For the director to exonerate himself from the disqualification time limit, would necessitate him going to court and pleading that he could now be responsible to act in management.

This provision was particularly onerous for those directors who held more than one directorship as it would involve them in the process of going to court to plead their case immediately. Even if the disqualification order was lifted, it would still effect the other companies in which he was involved.

The provision became increasingly objectionable for several reasons. The delinquent director would certainly be caught in its ambit, but so also would the 'honest but unfortunate' type of director whose inability to manage the company appropriately was due to inexperience rather than fraudulent intent. It would clearly make those directors who were facing financial difficulty more nervous about their companies, and thus would prompt them to be more prone to winding-up the company prematurely.

However, on December 10 1984 the Insolvency Bill was first presented to the House of Lords, the proposal for automatic disqualification was duly incorporated¹⁶. This manifested itself as an error of judgement on behalf of Parliament and the Department of Trade & Industry (DTI), who had initiated the legislation. The lack of preliminary debate which might well have mitigated the draconian measure before it entered the House of Lords, resulted in a flurry of lobbying amongst those sectors of society which would be adversely affected by the provision. The Confederation of British Industry and the Institute of Directors, successfully enlisted Parliamentary support not just from the Conservative majority in the House of Commons as well as their 'natural' majority in the House of Lords, but also members of the Opposition. The result was that a highly contentious debate followed and 1200 amendments were made to

¹⁶ See clauses 7 - 14 inclusive of the Insolvency Bill 1984 (No. 29).

the Bill. The Bill remained intact however, on many procedural points and points of principle¹⁷.

When the provision relating to directors disqualification was eventually enacted it was considerably less robust than the provision in the White Paper¹⁸. For example, individual directors may be disqualified from management when the company is insolvent, for a period of between two and fifteen years, but subject first of all to a court order. The burden of proof is thus switched to the person seeking the order, the only persons eligible to do this being the Secretary of State or the Official Receiver, acting on his behalf.

This results in the director facing a far less immediate or powerful call for disqualification, as any application by the appropriate authority, must come as a result of the (DTI) making an investigation. The law thus detracts from its objective of being a deterrent against the delinquent director. The administration of the proceedings in themselves may not carry on beyond the two year time limit for bringing such an action, leaving the director with the feeling that there is a sporting chance of survival, in view of the elaborate reporting from the liquidator to the Secretary of State in order to obtain the disqualification order¹⁹.

This was perhaps an opportunity missed as far as those who wished to see tougher sanctions against those directors who disregarded their privileges in the limited company. The Cork Report had advocated that it should be made possible for the creditor and the liquidator to be able to make a claim for disqualification against the director. This arguably would have provided a more potent threat where the time limit for such a claim would become closer in propinquity to the actual misfeasance.

¹⁷ Supra 3.

¹⁸ Insolvency Act 1985, s 12, now enacted as ss 6 & 7 of the Company Directors Disqualification Act 1986. See Appendix 1.

¹⁹ See S.I. 1986 Nos. 2067 and 2134, S.I. 1987 No. 2023.

One provision that complied in part with the recommendations of the Cork Report, was that relating to wrongful trading²⁰. Here, the liquidator can apply to the court for an order for disqualification in addition to making the director liable for company debts. The effectiveness of this provision has however been the subject of debate which has resulted in appraising whether the very basic philosophy of modern insolvency law is an appropriate measure for dealing with corporate governance²¹.

The objective of the Cork Report was to create a standard for directors in their duties to others within the corporate nexus which would be perceived as constituting a barrier which if transgressed, would make the director liable for the company's debts. In creating a scenario which it was hoped would engender fear of personal liability amongst directors, the Cork Committee expected that it would raise the level of consciousness of the director to the responsibilities of his position, through seeking affirmation from creditors before any further money is advanced²².

In structuring such a standard, the Committee saw the need to balance two sometimes opposing objectives. Firstly, to administer penalties where in the course of the company's failure:

"the conduct of officers or agents, merits criticism or punishment, while also providing means for the preservation of viable commercial enterprises capable of making a useful contribution to the economic life of the country." (para 198 Cork Report)_

The Committee concluded that such objectives would be best facilitated in a:

"framework of law ...", which would "command universal respect and observance, and yet is sufficiently flexible to adapt to and deal with the rapidly changing conditions of our modern world; in particular, to achieve a system that:

²⁰ Insolvency Act 1985, ss 15 - 16. These provisions are now enacted as ss 214 & 215 of the Insolvency Act 1986. See Appendix 1.

²¹ See inter alia Williams and McGee, Wrongful trading, Chartered Association of Certified Accountants, London 1992.

²² Cmnd 8558, para 1799.

- i) is seen to produce practical solutions to financial and commercial problems,*
- ii) is simple and easily understood,*
- iii) is free from anomalies and inconsistencies,*
- iv) is capable of being administered efficiently and economically.”²³*

The concept known as wrongful trading, initiated in S. 214 of the 1986 Insolvency Act is probably the most ambitious provision implemented in the Act, not only to fulfil the objectives of creating a higher standard for directorial activity, but also to make the Insolvency Service a more respected institution for policing management. S. 214 of the Act provides that where:

“in the course of a winding up of the company it appears that ...a person is or has been a director of the company, the court on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.”

Such a contribution is to be made where:

- i) the company has gone into insolvent liquidation,*
 - ii) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation,*
- and*
- iii) that person was a director of the company at the time.²⁴*

The legislation clearly tried to establish an objective standard by which the activities of directors could be assessed. By imposing the threat of personal liability, it was felt that directors would comply with a legally imposed standard of behaviour which would satisfy their peers, as to the commitment to commercial propriety. It was to seek the satisfaction of the reasonable man and thus objectifies what had previously been a matter of speculation and uncertainty²⁵.

The concept heralded a departure from the previous redress available for those against whom the director had committed an act of financial mismanagement. Previously, the only redress which the creditor had against any financial mismanagement in an insolvent company, was to

²³ Supra 11, para 198.

²⁴ Insolvency Act 1986, s 214(2). See Appendix 1.

²⁵ Supra 21.

be found in fraudulent trading, civil liability for which is now found at S 213 of the Insolvency Act 1986. Under this section, the creditor seeking some form of financial return from a director personally, had to show that:

- i) *"If in the course of the winding - up of a company it appears that any business of the company has been carried on²⁶ with the intent to defraud creditors of the company²⁷ or creditors of any other person or for any fraudulent purpose..."*

then

- ii) *"The court on the application of the liquidator may declare that any persons who were knowingly parties to carrying on the business in [that] manner are to be liable to make such contributions (if any) to the company's assets as the court thinks proper."*

The director had to be dishonest; carrying on the business with the "intent to defraud creditors of the company or creditors of any other person.", s 213(1).

The concept has replaced the provision found at S 332 of the Companies Act 1948²⁸. The stipulation created a widely defined criminal offence of carrying on the business of a company with intent to defraud. It further provided that, if a company was in the course of winding-up, the courts could declare that the culprits were to be personally responsible without limitation of liability for all or any of the debts or other liabilities of the company to the extent that the court might direct.

The concept had both a criminal and a civil aspect to it, representing the two objectives of punishing the director as well as compensating, and thus protecting, the creditor. The criminal aspect of fraudulent trading can now be found in Section 458 Companies Act 1985.

²⁶ It may be regarded as carrying on business notwithstanding that it has ceased active trading: *Re Sarflax Ltd.* [1979], Ch 592.

²⁷ It suffices if only one creditor in the course of one transaction is defrauded: *Re Coopers Chemicals Ltd.* [1978] Ch 262. Or of those defrauded are customers who are not actual, but only potential creditors: *Re Kemp* [1988]Q.B 645 c.a (pet. dis [1988] 1 W.L.R 846 H.L.)

For many debtors it was all too easy to circumvent the necessary mens rea required for fraudulent trading to be proven. In the case of *William C. Leitch Brothers Limited* [1932] Ch 71, Lustgarten J pointed out that the inability to pay debts was not enough to make a transaction fraudulent. This afforded the director the opportunity of pleading that incurring credit while knowing the company was insolvent, was merely an illustration of a cash flow problem. For those who could show a previous course of dealing which prompted them into such a situation, the evidential burden to prove their innocence was made that much easier²⁹.

The director who could show that he genuinely believed that "the clouds would roll away and the sunshine of prosperity would shine upon him", was thus exonerated from any personal liability," per Buckley J in *re White and Osmond (Parkstone) Ltd.* 30th June 1960 (unreported). This was so, regardless of the inadequacy of the decision that was taken, in terms of knowledge of the industry or the market in general.

The Jenkins Committee 1962, and subsequently the Cork Committee 1982, responded to the inadequacies of the former system, by initiating a concept which required a lower standard of mens rea. The Jenkins Committee had advocated the concept of "reckless trading", while the Cork Report chose the concept of wrongful trading³⁰.

The initial wording of the concept of wrongful trading, advocated by the Cork Report, linked it very closely to its predecessor, seeing it very much as an evolutionary extension of fraudulent trading. The draft proposed by the Cork Report, included both the intent to defraud creditors while establishing a more objective standard of behaviour by making a director liable in situations where he carried on trading but "ought in all the circumstances to have known" that the company's trading was wrongful³¹.

²⁸ As amended by s 96 of the Companies Act 1981, which reversed the effect of the decision in *DPP v Schildkamp* [1971] A.C.I (H.L.) holding that winding-up of the company was an essential precondition to a criminal prosecution.

²⁹ *Supra* 21.

³⁰ Cmnd 8558.

Establishing an Objective Standard

The diversity in the objective of wrongful trading from its predecessor, was illustrated when on commenting on the effects of fraudulent trading, Judge Bromley QC held that the civil action of fraudulent trading :

*"was in the nature of a punitive provision"*³².

It thus followed that the compensation payments made by the director as a result of fraudulent trading contained a punitive element. This was reflected in the requirement of a high standard of mens rea in order to bring a successful claim. The court, through the necessity of actually requiring an element of dishonesty, was in a position to justify a punitive award although the frequency of the application was impaired by the all too easy circumvention of the provision.

Parliament's desire to word the new provision of wrongful trading so differently suggested that it was to change the philosophy of the policing provisions from one of penalising the director to compensating and thus protecting the creditor.

Knox J in *Re: Produce Marketing Consortium* stated that :

*"In (my) judgement the jurisdiction under section 214, is primarily compensatory rather than penal."*³³

However, the position is less clear when he goes on to state that :

"The fact that there was no fraudulent intent is not of itself a reason for fixing the amount at a nominal or low figure, for that would amount to frustrating what I discern to be Parliament's intention in adding section 214 to section 213 in the 1986 Act, but I am not persuaded that it is right to ignore that fact completely."

³¹ Supra 1, para 1806.

³² *Re a Company* (No. 001418 of 1988).

³³ [1989] BCLC 520 (Chancery Division)

The statement highlights the reluctance of the judiciary to see the perimeter of the insolvency laws which give them policing powers as being devoid of some element of blameworthiness worthy of a quasi-sentencing criteria³⁴.

The quote by Knox J indicates the ambiguity surrounding a provision which demands a clearly defined objective if the courts are going to be able to interpret the provision with some degree of consistency³⁵.

The perception of S 214 losing its purely civil nature and becoming a quasi criminal sanction is to some extent influenced by the personnel involved in its execution and the perception society has in that execution being made. As Feinberg writes:

"The principle that the need to prevent harm to persons other than the actor is always a morally relevant reason in support of proposed state coercion. I call the harm to others principle (the harm principle for short). At least in that vague formulation it is accepted as valid by nearly all writers. Controversy arises when we consider whether it is the only valid liberty limiting principle, as John Stuart Mill declared." ^{36 37}

In looking at the procedural aspect of wrongful trading, it is relevant to look at those who are capable of initiating an action, in deciding whether there are any criminal overtones to the concept which are the remains of its pedigree.

The action can only be brought by an official qualified according to the requirements of legislation. It is not open to those who are aggrieved by the wrongdoing of the defendant. In

³⁴ Dine, "Wrongful Trading-Quasi Criminal Law. Insolvency Theory and Practice, Rajak. 1993 Sweet & Maxwell LONDON.

³⁵ Defining the concept of insolvency demands certain pre-requisites. As the corporation may be "balance-sheet" insolvent but will be able to continue to trade, or "cash flow insolvent" which will pre-empt the corporations creditors into seeking an early realisation of assets as the corporation becomes paralysed.

³⁶ The Moral Limits of Criminal Law (OUP, 1990), Vol. 4, p ix.

³⁷ See also Feinberg, op cit. Vol. 4, Chap 32 for a discussion of the morality using criminal sanctions in relation to "wrongful gain" which has no immediate obvious victim.

this respect it closely resembles the criminal process³⁸. Wrongful trading also carries with it the sanction of disqualification, which is at the discretion of the court³⁹.

In discerning the objective of the concept, it is important to incorporate those elements of the section which operate to effect the lives of those against whom the claim is brought.

The value of any measure, is determined:-

- i) by the degree of condemnation to which the defendant will be subject as a result of the outcome of the case and,
- ii) by the degree to which the result will affect the future life of the defendant, including his capacity to make a living.

If the degree of these factors is sufficient to go beyond compensating the victim, then it will roam into the realm of punishment for the defendant. If the objective of the civil procedure is compensation there is a good and sufficient method of distinguishing between that and a punitive fine. If the amount paid by the defendant or the penalty to be suffered by him relates to his behaviour rather than to the loss suffered by the victim, that is a clear indication that punishment of the defendant rather than compensation to the victim is the issue under consideration by the court⁴⁰.

An example of this objective is found in *Re: A Company (No. 001418 of 1988)*⁴¹. Here, the parameter of the concept incorporated those elements of penal consequence which makes the perception and thus the outcome of the concept criminal in its nature.

Naming the concept, as wrongful, suggests a degree of condemnation from society. It emphasises the anti-social behaviour of those who practise it, and initiates the idea of blame being attached to one person because of loss to an innocent party.

³⁸ Ante 25.

³⁹ Company Directors Disqualification Act 1986, s 10. See Appendix 1.

⁴⁰ Supra 27.

The effect on the perception of wrongful trading, is to employ it only as a means of obtaining a just solution to a particular set of circumstance, rather than to compensate the creditor for loss. When Knox J therefore quotes that he will not disregard fraudulent intent in assessing the damages to creditors, he consciously moulds the concept of wrongful trading into a solution, the path to which is paved with criminal considerations.

The problem lies in the many factors which the civil court balances in reaching its decisions, for with all the legislative provisions at its disposal, it is conscious of the fact that it has the power to severely restrict the freedoms of those upon whom it makes judgement.

The intention of Parliament, as illustrated by the Cork Report, does not help the dilemma. On the one hand, it emphasises the compensatory element when it states :

*"It is right that it should be an offence to carry on a business dishonestly; and right that in the absence of dishonesty no offence should be committed. Where however, what is in question, is not the punishment of the offender, but a provision of a civil remedy for those who have suffered financial loss, a requirement that dishonesty be proved is inappropriate..."*⁴²

However when the report goes on to justify the new concept, the idea of it acting as a deterrent, with retributive overtones in mind is illustrated when it is argued:

*"...a climate should exist in which downright irresponsibility is discouraged and in which those who abuse the privilege of limited liability can be made personally responsible for the consequences of their conduct."*⁴³

The dual nature of the objective, indicates the confusion which was to be found at the time of initiating the 1986 Act. As Fletcher indicated :

*"It was suddenly felt to be important for the government to be seen to be facing up to the issues of incompetence - even downright delinquency - on the part of directors and managers of companies."*⁴⁴

⁴¹ [1991] BCLC 197.

⁴² Supra 1, para 1777.

⁴³ Supra 1, para 1805.

The White Paper which followed shows that while the more draconian action of automatic disqualification was lost,⁴⁵ there was a clear indication by the Government that the measure would act as a deterrent and thus wrongful trading was given its punitive dimension.

The Court's Response to Wrongful and Fraudulent Trading

The evolution of 'fraudulent trading' with its criminal background is, as already illustrated, divided into a criminal and a civil remedy⁴⁶. In order for a claim to be successful, the plaintiff must show that the defendant acted with 'intent to defraud', and that the directors were not just acting unreasonably, but also dishonestly. This is determined by factual deduction of each individual case, with its obvious subjective analysis⁴⁷. The section therefore brings the sword of the criminal law firmly into the area of insolvency.

Wrongful trading however, is ostensibly the weapon of the civil courts and unlike fraudulent trading, an application can only be made once a company has gone into insolvent liquidation, i.e. gone into liquidation at a time when its assets are insufficient for the payment of its debts. Also an application may only be brought against a director or a shadow director⁴⁸.

One of the most revolutionary departures which wrongful trading made from its predecessor was that it sought to make objective the standard of care owed by directors and shadow directors to creditors. Clearly there is a demand from the provision that the director or shadow director ought to have concluded that the company would not avoid insolvent liquidation and not that they did know that fact and were dishonest in concealing it.

⁴⁴ Supra 2.

⁴⁵ Cll 7-14 of the Insolvency Bill 1984.

⁴⁶ Section 458, Companies Act 1985 and S 213 Insolvency Act 1986 respectively.

⁴⁷ Re Todd (Swanscombe) Ltd. [1990] BCC 125.

⁴⁸ Section 214 (1) and (7) Insolvency Act 1986.

The thinking of the courts regarding the standard of care was well explained by Knox J in *Re:*

Produce Marketing Consortium Ltd. (No. 2) ⁴⁹. He said :

"It is evident that Parliament intended to widen the scope of legislation under which directors who trade on when the company is insolvent may, in appropriate circumstances be required to make a contribution to [a company's creditors]... the test to be applied by the Court has become one under which the director in question has to be judged by the standards of what can reasonably be expected of a person fulfilling his functions and showing reasonable diligence in doing so... [t]he general knowledge skill and experience postulated will be much less extensive in a small company in a modest way of business with simple accounting procedures and equipment than it will be in a large company with sophisticated procedures. Nevertheless certain minimum standards are assumed to be attained.... [Wrongful trading is] an enhanced version of the right which any company would have to sue its directors for breach of duty- enhanced in the sense that the standard of knowledge skill and experience required is made objective."

However, in establishing such a standard, the aims of the legislation are an important part of the judiciary's considerations. So far as Knox J was concerned in *Re: Produce Marketing Consortium* ⁵⁰ the situation indicates only confusion. In context he stated :

"In my judgement the jurisdiction under section 214 is primarily compensatory rather than penal. Prima facie the appropriate amount that a director is declared to be liable to contribute is the amount by which the company's assets can be discerned to have depleted by the director's conduct which caused the discretion under subsection (1) to arise. But Parliament has indeed chosen very wide words of discretion, more especially since this is, so far as counsel were aware, the first case to come to judgement under this section. The fact that there was not fraudulent intent is not of itself a reason for fixing the sum at a nominal or low figure, for that would amount to frustrating what I discern as Parliament's intention in adding section 214 to section 213 in the 1986 Act, but I am not persuaded that it is right to ignore that fact totally."

Clearly, while expressing the compensatory objective of the legislation, Knox J illustrates that the quasi-criminal overtone of the section is not to be ignored and thus the ambit of the section suddenly becomes subject to considerations of penalty which are entrenched with matters which are subjective and are to be viewed very much on the facts of the each case. This in turn serves to undermine the certainty which is usually to be expected from objectivising the mental element of a particular legal principle.

⁴⁹ [1989] BCLC 520, pp 549-550 and 553.

⁵⁰ *ibid*, p 553.

With the inclusion of these subjective matters, wrongful trading is held to judicial interpretation by standards which are not defined completely. The result is that while the concept is viewed with gravity by the courts, the scope of the penalty will still be determined by the mens rea of the directors⁵¹.

⁵¹ Supra 27.

CHAPTER 3

WRONGFUL TRADING: A CASE LAW STUDY

In this chapter, I will examine the practical application of the wrongful trading provision and its interpretation by the courts. Perhaps the greatest indictment of the Cork Report's expectations for the provision of wrongful trading has been the pitifully few cases which have been decided by the courts. This has been so, despite a rise in corporate insolvencies during the last eight years; forty thousand alone for the period 1992-3¹.

The first and arguably the most significant examination of an insolvent liquidation for the purposes of Section 214, came in the case of *Re Produce Marketing Consortium (No 2)* ². Here, the company was run by two people, both directors, and its business was the importation and distribution of citrus fruit. It retained a commission of 3.5% on all fruit imported and distributed and as it required £35,000 to cover its annual costs (including the remuneration of the two directors) it had to have a turnover of at least £1m to break even. In fact, for virtually the entire six year period prior to liquidation, the turnover was less and not surprisingly, the bank overdraft rose from nil in 1980 to over £91,000 in 1984. The overdraft limit was agreed at £75,000 but this was frequently exceeded. Close to liquidation however, it was substantially reduced. This did not occur through any additional income received by the company, but at the expense of the company's major supplier, the citrus produce and exporting company in Cyprus which at liquidation was owed £175,000 (unsecured); in fact one month before liquidation, the overdraft had been reduced to about £57,000, a debt which was almost entirely covered by the personal guarantee of one of the directors. Had it not been for the continued support of the bank, the company would have been forced into liquidation much earlier.

¹ Figures supplied by the Department of Trade and Industry, "The Insolvency Report" 1993.

In the course of a long judgement with detailed examination of the company's history, it was revealed that the company's accounts were often presented later than the time limit prescribed by the Companies Act³. The draft accounts for the periods 1984/85 and 1985/6 were produced in January 1987. Those for the period 1984/5 should have been produced not later than July 1986. When they were produced, they revealed a trading loss of over £50,000, and an excess of liabilities over assets of £175,000.

On the basis of these figures the court held that, as at July 1986, the directors ought to have concluded that there was no reasonable prospect that the company would avoid insolvent liquidation. The court selected this date because it represented the date that the company ought to have realised the disastrous state of its financial position which could have been discerned by viewing the accounts which should by then have been finalised and presented. Here the court relied on the assessment of the reasonably diligent person as one who has a certain amount of knowledge, including the details of the accounts by the last date by which they should have been presented⁴.

In this conclusion, the court furnished the legislation with a definition of insolvency. This has, however, led to further ambiguities in defining the section. Under S 214(7), the company goes into insolvent liquidation when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding-up. The test for insolvency was on the balance sheet and not on the liquidity basis (the Cork Report had suggested that either would be appropriate (para 1806)). However, the Act gives no indication as to whether the assets should be valued on a 'going concern' basis which includes the invisible asset of goodwill or that the break-up basis should be applied⁵. The reference to 'going concern' in the making of business

² [1989] BCLC 520.

³ Section 224, Companies Act 1985.

⁴ Ante 2, page 550, paras g and h.

⁵ The choice of test is important as the "break-up" test of corporate assets, which values the corporation in terms of the fixed assets which it has to sell, It will provoke the keenest interest from creditors who see that the corporation is to be wound-up. The surge that follows from creditors will further undermine the already deflated value of the corporation, and thus places a detrimental effect on the value of the company. For further reading see

judgements in S 214 (2)(b), supports the idea that it would be wrong to judge the matter with hindsight, simply on the basis that some of the assets had to be sold on a piecemeal basis, and that a 'going concern' basis is felt to be more appropriate⁶. The section displays a further degree of uncertainty as to the overall effectiveness of the clause by not making it clear in what circumstances the section will 'bite'.

The next question was whether, between July 1986 and October 1987, when the company was in liquidation, the respondents (the two former directors) took every step that reasonable diligent people in their position would have taken to minimise loss to creditors⁷. On the facts, which clearly indicated that the company had been in a financially deficient state from the beginning, the answer was no. The respondents argued that a date later than July 1986 was more appropriate for the conclusion that insolvent liquidation would take place, and that from that later date, they had taken all such steps in that they had only continued trading in order to sell a cargo of stored fruit at the best possible price. The court rejected the later date and found that even after the later date other trading continued in addition to the attempts to sell the stored fruit⁸.

Under the section, the court has a wide discretion as to the order to be made where wrongful trading is found to have existed. Given that the section is solely, as the court put it compensatory an assessment has to be made as to the cost to the creditors of the failure to act diligently in accordance with the section. Here the order was that both respondents contribute £75,000 to the assets of the company. In fact, this was much less draconian than it sounds, as one of the directors who had personally guaranteed the overdraft was responsible for a contribution of £50,000 anyway (the amount of the guarantee). Although the order was

R.M.Goode "Wrongful Trading and the Balance Sheet Test for Insolvency", JBL (1989), p436.

⁶ L.S.Sealy : Disqualification and Personal Liability of Directors (Fourth Edition), Chapter 6, 1993.

⁷ Section 241(3). This provides the director or officer of the company with a defence of "good faith" if he can show that he did everything possible to control the damage done to the creditor. For further practical steps which the officer can employ to show this, see Draper "Companies in Trading Difficulties: The Pitfalls for Directors and How to Avoid Them", International Company and Commercial Law Review, Vol. 11, 1993 p 400.

against both directors jointly and severally, i.e. that either was responsible for the entire amount, the court ordered the director responsible under the personal guarantee to indemnify the other to the extent of £50,000.

The case is important not just because it was the first to be decided, but also because it illustrated the court's ability and willingness to embark on a detailed examination of the company's history leading up to the liquidation, and while being sympathetic to the company's position, was nevertheless firm in its judgement⁹.

This decision based on the application of S 214 Insolvency Act 1986, displays both a subjective and objective standard for the duty of skill and care owed by the directors to the corporation and to its creditors. This Knox J. believed represented the different objectives of the new concept. Knox J. accepted that "regard must be had to the particular company and its business; hence it followed that the general skill, and knowledge and experience postulated will be much less extensive in a small company in a modest way of business, with simple accounting procedures and equipment, than it will be in a large company with sophisticated procedures"¹⁰.

However, compliance with the accounting obligations imposed by statute must be presumed,¹¹ moreover, since S 214(4) refers inter alia to :

"facts which a director...ought to know or ascertain"

the fact that the accounts were actually prepared late would not prevent imputed knowledge of factual information, but at any rate, knowledge of the situation could be presumed considering

⁸ Supra 2, page 552, paras a and b.

⁹ Rajak (1989) 139, New Law Journal, 1374 & 1458.

¹⁰ Supra 2, page 550, para c. This has led to much debate on the employment of the section in providing a new general objective standard for company directors. See Hicks "Advising on Wrongful Trading :part 1", 1993, Company Lawyer, Vol. 14, no.1, page 16, together with part 2, Company Lawyer 1993, Vol. 14, no.3, p 55.

¹¹ Supra 3.

the extent of the deficiency of assets over liabilities, ascertainable with reasonable diligence and an appropriate level of general knowledge, skill and experience. The directors should, therefore, have concluded midway through 1986, that the company had no reasonable prospect of avoiding insolvent liquidation.

Factors listed by the judge as affecting his exercise of discretion in the case included that:

- i) The directors had failed to appreciate what should have been clear, rather than indulged in deliberate wrong-doing; nevertheless at the time, positive untruths had been stated, exceeding unwarranted optimism.
- ii) The auditor's solemn warning had in effect been ignored.
- iii) Debtor balances of sizeable amounts shown in the company's ledgers did not figure at all in its liquidation statement of affairs; the question of disappearing debtors was of significance and could not be ignored.
- iv) One of the directors had personally guaranteed the company's overdraft up to £50,000, and the bank had a charge over the company's assets which would embrace anything the directors were ordered to contribute and would *pro tanto* relieve the director who had given the guarantee from his liability under it.
- v) During its final months of trading, the company's affairs were conducted in a way which reduced its indebtedness to the bank, for which a director stood guarantor at the expense of the trade creditors¹².

However, the judge concluded that the facts were not ambiguous. Clearly the company had fallen foul of the insolvency provision by continuing to trade. The directors had been

¹² Supra 2, pages 553-554, paras c-f.

negligent in their handling of those communicative elements of corporate governance, which should have told them that something was wrong; i.e. the failure to keep up to date accounts for their inspection. As a result, the section provided for compensation from the directors leading to an expectation that the section would become a preventative weapon in the armoury battling against cavalier directors¹³.

The communication of the state of the corporation to the directors which would then be translated into action to minimise the loss to creditors was an important element in the reasoning of *Re DKG Contractors Ltd.*¹⁴. Here a husband and wife traded as a groundworks subcontractor from 1979 to 1988, and incorporated the business in 1986. The company did not take over the outstanding contracts owned by the proprietor, Mr. Gibson, but rather paid them as if the company had sub-contracted to the former business. The result was that the company was invoiced for work done by the firm owned by Mr. Gibson.

After some time, Mr Gibson became the company's major creditor. However, during 1988 the company faced financial difficulty and no fewer than sixteen creditors obtained judgement for debts between May and November of that year. Subsequently the company went into creditors' voluntary liquidation in December 1988 with an estimated deficiency of over £260,000.

There were basically three areas for the courts to deal with in the case. First, the question of Mr. Gibson receiving a salary of £417,763 from the company in the ten months before the company went into liquidation. The company paid Mr Gibson for the works which his firm had carried out on the company's behalf. However, the company and Mr. Gibson were connected persons and therefore the transactions were in effect placing Mr. Gibson in a preferential position in contravention of S 239 Insolvency Act 1986. This constituted an act of wrongful preference and as a result, the money from the transaction ought to be repaid in spite

¹³ See inter alia, "Wrongful Trading - The Start of Something Big", Nicholas Bourne, Business Law Review, April 1995 p 79.

¹⁴ (1990) BCC 903 .

of the defence's arguments that the money was justified on the ground that the defendants were simply being reimbursed for the works which the firm owned by Mr Gibson had done, and that the defendants had acted honestly and reasonably, and ought reasonably to be excused under S 727 Companies Act¹⁵.

Second, the question of the directors' duty to handle the creditor's money in accordance with the common law standard of care, which finds redress, in S 212 Insolvency Act 1986¹⁶. Here the court concluded that the directors had misapplied and retained money belonging to the company, for the benefit of Mr. Gibson, who as a result of the transactions between the company and himself, became accountable for the money.

Third, came the question of wrongful trading. In his judgement, Sir John Weeks QC, spoke of wrongful trading as "an alternative remedy to fraudulent trading"¹⁷, thus immediately emphasising the evolutionary connection with the former, penal provision now incorporated by S 213 of the Insolvency Act 1986. The fact that Mr. & Mrs. Gibson were inadequate for the task of running a company was also emphasised,¹⁸ but as a factor which would not protect them from the provision. The only factor relevant for the judge was determining a date when the couple ought to have concluded that there was no reasonable prospect of the company avoiding liquidation¹⁹.

The judge differed from the view of the defendant as to the time when they should have concluded that the company ought to be wound-up. This was when the first creditors began to press for their money at the end of April. At that point, the defendant was also aware that a supplier refused to make further deliveries to the company which caused the defendant to have a row with his wife.

¹⁵ Ibid, p 903, para g.

¹⁶ This focuses on the director's action during or immediately before the liquidation has taken place, and makes a director personally liable for monies which have been misapplied or retained, or has committed any misfeasance or breach of fiduciary duty, S 212 (1)(c).

¹⁷ Supra 14, p 912, para b.

¹⁸ Ibid, p 912, para b.

¹⁹ Ibid, p903, para h.

The couple had employed someone to prepare quotations for work; Mr. Broomfield. He had assured the couple that monies would come in to cover those laid out to the defendant. The judge's response to this was to look at the adequacy of the return, and found that this fell well short of the amounts given to the defendant. In any event, Mr. Broomfield's job had not been to analyse whether this would be sufficient monies to cover the expenses, only to supervise the income. Any such analysis would have to come from someone who had access to the accounts book, and that was the defendants²⁰.

The judge concluded that from the middle of April when the warning signs were showing, some form of financial control should have been placed on the company. If this had been done, the directors would have seen that there was no reasonable prospect of avoiding liquidation. The directors became liable for repayment of monies as from the 31st April.

The cases attempt to define some of the sections in this part of the Insolvency Act, by attaching to them a certain philosophical basis. The fraudulent trading reference shows that while the provision of S 214 has been classed primarily as compensatory²¹, the pedigree of dishonest intent was still a factor fashioning the judges view that the objective of the section contains an element to penalise the director²².

This fact seemed to be illustrated in the judgement of John Weeks QC, when he stated, that he has little sympathy for the defendant or his wife, and that his major sympathy lay with those unpaid creditors who extended credit to the company in all innocence²³.

²⁰ Ibid, p 912, para d.

²¹ Supra 2.

²² Ibid, p 544, para a. The judge considered it relevant to mention that the pay awards to the directors while reasonable per se, did look less than reasonable in the context of the company's performance. The judge's remarks inferred that it was important to him to look at the "honesty" factor in the case even though his final conclusion (ante) was that dishonesty was not an important factor.

²³ Supra 14, p 908, para e.

This comment is contradicted later in the judgement, when John Weeks makes it quite clear that the defendants had not acted dishonestly²⁴, believing that the scheme used to run both the company and the firm was not done with the intention of avoiding personal liability. Nevertheless, the defendants had acted unreasonably in trading in the manner they had. This was enough to incur liability under the section²⁵.

The case displays that there is an undefined conceptual area of legal thought between the realms of dishonesty and unreasonableness, which includes concepts such as recklessness and gross negligence. While the judge in the case was prepared to admit that the defendants were not dishonest, there is from his judgement, a lack of sympathy for the defendants which suggests a moral culpability which extends beyond that of concluding that someone has been unreasonable.

However, the argument that wrongful trading is primarily a compensatory measure, is illustrated by the judges decision to allow the money which the directors had to return under the wrongful trading provisions, to be partly satisfied by the provisions relating to S 212 Insolvency Act, that of misapplication of funds and S 239, relating to wrongful preference. Both these sections are compensatory in their application and thus were seen by the judge as fulfilling the compensatory element of S 214²⁶.

The case of *Re Purpoint Ltd.*²⁷, also illustrates the court's predilection for using the company's method of keeping accounts as determining the date upon which the directors ought to have concluded that the company could not avoid going into insolvent liquidation²⁸.

In that case the director, Mr. Meredith, ran a company engaged in retailing photographic equipment, which never actually produced accounts, and was erratic in paying its debts. No

²⁴ Ibid, p 912, para h.

²⁵ Ibid.

²⁶ Ibid, p 912, paras e and f.

²⁷ [1991] BCLC 491.

²⁸ Ibid, p 491, paras e - g.

significant procedure was established for paying the Inland Revenue's PAYE, with the result that £19,723.43 became outstanding by the end of 1986. Also, there were a number of occasions in 1986, when creditors had to take action through the county court in order to secure payment. The court was not disposed to believing the defendants' claim that they actually reviewed the company's position at the end of each month²⁹.

A meeting did take place between the defendants and a Mr. Adamson, in May 1987, in which Mr. Meredith was advised to stop trading, as to continue in the insolvent state which the company now found itself would result in the defendant incurring personal liability for company debts³⁰.

The overall total of liability at the date of liquidation was £63,685. In his summing up Vinelott J. stated:

*"I have felt some doubt whether the reasonably prudent director would have allowed the company to commence trading at all."*³¹

Yet he was not convinced that the commencement date was the most appropriate date on which to start calculating liability under S 214. Also, the date at which Mr. Meredith took advice from Mr. Adamson was considered too late to determine the date for liability.

The judge clearly saw that the responsibilities for management would be allowed some degree of risk at the beginning of trading, but that the defendant could not protect that risk through seeking professional advice from an accountant³². The court showed that it had expectations of the director to take certain responsibilities for himself and these were clearly manifested by the production of company accounts, and a reasonable response to them.

²⁹ Supra 27, p 493, para i.

³⁰ Ibid, p 494, paras h and i.

³¹ Ibid, p 498, para c.

³² Ibid, p 495, paras c and d.

The case also raises other aspects of the provision, which have been the source of debate in interpreting the section. In *Re Purpoint*³³, Vinelott J. was acutely aware of the need to show that the provision was to be used as an extension of the sacred concept of *pari passu* when he states:

*"The purpose of an order under S 214, of the 1986 Act, is to recoup the loss to the company so as to benefit all of the company's creditors and the court has no jurisdiction to direct payment to a particular class of creditor."*³⁴

However Knox J. in *Re Produce Marketing Consortium*, was prepared to give one group of creditors a more privileged position, by making their approval of the directors' actions, a reason for greater conviction in the idea that the directors had a defence that they were trying to improve the position of the creditors by continuing to trade. In reply to this defence, Knox J. states:

*"These are fine sentiments but they would carry more conviction if Romana had been given the opportunity to decide for itself if it wanted to avail itself of PMC's marketing expertise."*³⁵

The statement suggests that if the directors had given its major creditors the opportunity of scrutinising the directors' actions, and approving them, then this would have somehow exonerated the directors' liability under the provision. This is contrary to the philosophy that all ordinary creditors rank equally regardless of the amount of their financial assistance to the company. It also detracts from the section's ability to act as a device designed to extend the general duty of the director by curbing deals which are contrary to S 239 of the Act³⁶.

The Defence to Wrongful Trading

³³ See ante

³⁴ Supra 11, p 491, para g.

The question of the provision's defence, was raised in the case of *Re Purpoint*³⁷ and in *Re Produce Marketing Consortium*³⁸ and others. The only defence which was afforded to the director is found in S 214 (3), which states that a declaration as to wrongful trading will not be made where the director could show that he had taken :

*"every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken."*³⁹

However, debate over the question of a dishonest intention forming a relevant factor for establishing a case of wrongful trading⁴⁰, have prompted many defendants to advocate a defence under S 727 of the Companies Act 1985. Under this section, the court has the discretion to grant relief from liability where it can be shown that despite the proceedings against a director "for negligence, default, breach of duty or breach of trust", the officer of the company can show that he acted "honestly and reasonably and that having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused."⁴¹

The section has been considered an inappropriate defence to the concept of wrongful trading for several reasons. First, wrongful trading is the provision initiated by the Cork Committee⁴² to combat those inadequacies in the fraudulent trading provision, which resulted in many directors who had acted unreasonably but not dishonestly in the continuing to trade. The wrongful trading provision was designed to fill a gap in the law.

³⁵ Supra 2, p 540, para c.

³⁶ See ante.

³⁷ See ante

³⁸ Supra 8.

³⁹ Steve Hill "The End Of Limited Liability as We Know It?", *Mind Your Own Business*, February 1990, p39. Here the question of S 214(3) is viewed as a defence to commercial misfortune, which may have involved the directors taking a risk which would breach S 214.

⁴⁰ See ante.

⁴¹ Section 727(1) Companies Act 1985.

The very demand that the section makes to the director acting reasonably, with the general knowledge, skill and experience that he actually has, suggests that the whole basis of the provision is to establish an objective standard, that may be one standard which reflects an appropriate level at which a company director may perform⁴³.

This point led Knox J. in *Re Produce Marketing Consortium* to consider S 727 as being “difficult to marry”, with the essentially objective nature of the provision⁴⁴. Section 214(4), imputes for the purposes of subsection (2) and (3) to a director not only the general knowledge, skill and experience that might reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to that company, but is in fact extended to cover not only to the functions that he did carry out but also the functions that had been entrusted to him⁴⁵. Thus the provision covers not just the things which the director did but not dishonestly, but also the abdication of those things which he ought to have done.

The Cork Committee had intended for the courts to have the power to grant relief from wrongful trading in hard cases. At paragraph 1793 it stated:

“We propose that, in cases where there is actual or constructive knowledge of the wrongful trading, a person who can establish that he has acted honestly and that the circumstances were such that he ought to be excused may apply to the court for relief from personal liability. The Court's power to give relief, deriving from S 448 of the Act [Companies] of 1948 and the analogous provisions of S 61 of the Trustee Act 1925, will be available to give relief in what otherwise would be regarded as hard cases.”

However, the analogy with the Acts of 1925 and 1948, proves somewhat inappropriate, when at the following paragraph, The Cork Committee states:

“Under our proposals no one can be made liable for wrongful trading unless he has acted dishonestly, or in some respects later, unreasonably. It would therefore, be inappropriate if relief could be extended only to those who had acted reasonably. There may however, be circumstances in which the honest

⁴² Cmnd. 8558, 1982, Ch 44.

⁴³ Section 214(4) Insolvency Act 1986.

⁴⁴ *Re Produce Marketing Consortium Ltd.* [1989] BCLC 513 at p 518, para b.

⁴⁵ *Supra* 8, p 518.

director ought to be relieved in whole or in part, and we do not wish those circumstances to be circumscribed in any way.”⁴⁶

The Government did not initiate the provision of wrongful trading based on the draft set out by the Cork Committee. Instead, the basis of liability was as a result of incurring further debt while insolvent, and continuing to trade⁴⁷. The emphasis was moved to one of failing to take every step to minimise the potential loss to creditors. This defence, intrinsic to the provision itself,⁴⁸ affords the courts complete discretion over the extent of the director's liability and no additional form of relief is therefore necessary⁴⁹.

It was this relationship between the two sections which Knox J. had to consider in the case of *Re Produce Marketing Consortium*, as no formal indication of any relationship between the two had been made. He concluded that S 214 expressly excluded S 727.

First, S 214 judges the director by way of an objective test which is irreconcilable with the subjective test of S 727. While it is clear that S 214 is not completely devoid of any subjective matters⁵⁰, Knox J. pointed out that:

“...certain minimum standards are to be assumed to be attained.”⁵¹

However, S 727 is itself not truly subjective. Reference is given to the director being given relief if he acted “honestly and reasonably and...having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused”. The fact that the word reasonably is used, suggests an objective element to S 727.

Conversely, in *Re Produce Marketing Consortium*, Knox J. observed that he would not disregard any fraudulent intent in assessing the amount of contribution which the director

⁴⁶ Cmnd 8558, para 1794, 1982.

⁴⁷ Ibid, para 1806, contrast the White Paper, “A Revised Framework for Insolvency”, para 52.

⁴⁸ Section 214 (3) Insolvency Act 1986.

⁴⁹ Bradgate & Howells (1990), *Journal of Business Law* 249.

⁵⁰ *Supra* 10.

⁵¹ *Supra* 2, p 550, para c.

would have to make as a result of wrongful trading. This imputes a subjective element, albeit at the stage of determining the extent of liability rather than if liability has taken place at all⁵².

As both sections contain the objective standard of acting reasonably as a criterion for their implementation, is it really that incompatible to use S 727 as a further defence to the provision of wrongful trading? In cases of negligence, the standard is objective, and S 727 can be used. In such cases the word 'reasonably' in S 727 might be taken to refer to a director who had nevertheless behaved reasonably in the light of his own abilities: there is no compelling reason why the court should not have the power to excuse the objectively incompetent but subjectively honest and reasonable director⁵³.

The decision taken by Knox J. not to use S 727, is perhaps an insight into the policy of the court not to compromise what Parliament had intended to be a most forceful weapon against those abuses of the insolvency law which led to the initiation of S 214. Section 214(3) does not provide a defence for the provision, but rather establishes a second condition which has to be fulfilled before the court can make an order⁵⁴. If it is shown that the director took all reasonable steps to protect the interests of the creditor then no order can be made. The courts clearly have taken the view that to compromise the provision by making it subject to the question of whether the director was honest, is to undermine the dramatic effect which the Government clearly had intended the provision to make⁵⁵.

In *Re Produce Marketing Consortium*, the two directors failed in viewing their accounts until several months after the accounts ought to have been prepared. This meant that they had failed to take every reasonable step to protect the interests of the creditors because a reasonable director would have prepared the accounts on time, and would have reacted accordingly. The directors could not have been accused of being dishonest in their intention so arguably their actions ought to have been subject to some sort of mitigating provision, like S 727.

⁵² Supra 22.

⁵³ Bradget and Howells "No Excuse for Wrongful Trading", JBL (1990), 249.

⁵⁴ As observed by the editors of Gore Brown on companies.

The final argument against the use of S 727 as a defence, comes from the application of the section itself in other areas of law. The Court of Appeal in *Customs & Excise Commissioners v Hedon Alpha Ltd.*⁵⁶ pointed out that S 727 could only be used in a situation where a claim against the director or officer was by the company itself, a fact raised by the editors of Gore-Browne, commenting on the *Hedon Alpha* case. They stated that S 727 “is applicable only in respect of a director's or officer's liability to his company under the Companies Act. It cannot be used to seek relief for default imposed on a company director by other legislation.”⁵⁷.

However, it is clear that the section can apply to S 212 of the Insolvency Act, relating to the retention or misapplication of money, thus illustrating that the section is in fact used outside the Companies Act⁵⁸. The section can be utilised by the company itself against its directors. This is a significant distinction from S 214 of the Insolvency Act, because there only the liquidator, an outsider, can bring a claim. It is clear that claims brought by ‘outsiders’, cannot rely on S 727 as a defence.

In *Re Produce Marketing Consortium*, Knox J. took the view that the liquidator was in fact an outsider, and was therefore outside the ambit of S 727⁵⁹. This approach can be subject to the criticism that while the liquidator is technically outside the company, his work is done on behalf of the company and his duty is owed to the company, making him just as much a part of that company as the director or shareholder⁶⁰.

The use of S 727 may prove redundant, as S 214 gives the court a wide discretion to order “such contribution (if any) ...as the court thinks proper,” to the creditors. This means that

⁵⁵ See Chapter 2.

⁵⁶ [1981] Q.B. 818.

⁵⁷ Ibid, para 27.21

⁵⁸ For a general application of the use of S 727 for misfeasance proceedings, see *Re Kirbys Coaches Ltd* [1991] BCLC 414. Also Halsbury's Statutes, 4th Edition, Vol. 4.

⁵⁹ *Supra* 2, p 4, para h.

⁶⁰ *Supra* 22.

while technically a claim for wrongful trading is successful, the outcome will result in the director being exonerated from any compensation payment to the creditor. Also, S 215 of the Insolvency Act 1986, empowers the court to "give such further directions as it thinks proper for giving effect to the declaration. "These are ...very wide words of discretion and it would be undesirable to seek to spell out limits on that discretion..."⁶¹.

The final order in *Re Produce Marketing Consortium (No.2)* illustrates the flexibility of the court's power. The two directors, one of whom had guaranteed the company's overdraft up to a figure of £50,000, were ordered to pay jointly and severally £75,000 to the company assets, but the director's guarantee satisfied only the first £50,000 of the order. Section 214 is thus to be seen as a self contained section, which was never meant to be fettered by a mitigating section, like S 727 of the Companies Act 1985.

The courts in not using S 727 as a means of a defence, have illustrated their wish not to compromise the expectations of the Cork Committee and the Government of providing the commercial community with a more stringent measure with which to combat the more cavalier amongst those in corporate power. Nevertheless, certain compromises have been made.

One of the more recent annunciation of the effect of the wrongful trading provision on the legal standards expected from directors came in the case of *Re D'Jan of London* ⁶². The case involved a summons under S 212 Insolvency Act 1986, where a company had a shortfall to its creditors upon liquidation of £500,000. The defendant, D, held 99 of the 100 shares, and the liquidator was bringing a claim for negligence against the director, for failing to insure premises in which stock valued at £174,000 was stored. The failure arose as a result of the director answering a question stating that at no time had he been involved in a company which had gone into liquidation. In fact, the director had been involved with an insolvent company, five years previously.

⁶¹ Supra 23, p 553, para f.

He admitted that the application form was filled in incorrectly, but also stated that he had not filled in the form, or seen the form before it was sent to the insurers. This he had entrusted to his insurance broker, Mr. Shenyuz, whose rates of pay and longevity of service culminated to make a presumption that the form would be filled in accurately. This form of events was disputed by Mr. Shenyuz, who claimed that he had merely delivered the form to Mr. D'Jan.

It was during the judgement that Hoffman J. stated that Mr. D'Jan had been negligent in not reading the form before signing it, commenting that the duties of the director were illustrated in S 214(4) Insolvency Act 1986. These were :

i) the conduct of someone with " the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to that company

and

ii) the general knowledge, skill and experience that that director has.

It was thus on the basis of this objective/subjective test that the director was found liable for negligence.

D'Jan was held liable to compensate the company for the loss incurred as a result of his breach of duty, and the amount was to be up to that amount he could have claimed in dividends, as an ordinary creditor. In their judgement the court held that the director had been negligent in the performance of his duties. It was no defence that he had not read the document, as this was something that need not be expected from a director⁶². It was also no defence that his actions may well have been ratified by the other shareholders, that is D' Jan and his wife.

⁶² [1993] BCC 646.

⁶³ Ibid p 648, para c.

The two important parts of the decision for the purposes of the legal objectives of wrongful trading, were that the duty of care owed by a director at common law, was accurately stated in S 214(4) Insolvency Act 1986, and that under both the subjective and objective test set out in that section, D had failed.

However, the court went on to say that as this was a case under S 212 Insolvency Act 1986, the subjective effects of the director's action could also be viewed in considering whether, under S 727 Companies Act 1985, he could be afforded a defence to his actions. As only he and his wife would suffer from his actions, it was clear that there had been no dishonesty involved but that there had been gross negligence. As a result, the director was excused from some but not all of the liability⁶⁴.

The section is analogous to the American provision of the "Business Judgement Rule"⁶⁵. This principle has been a part of the American principles of corporate governance for over one hundred and fifty years. It acts as a shield against personal liability for the director where his decision has caused commercial mismanagement. The essential elements are:

- (i) that there was an absence of personal interest or self-dealing by the director,
- (ii) that it was an informed decision, which reflects a reasonable effort (subject to permitted reliance on the advice and efforts of others),
- (iii) there was a reasonable belief that the advice would serve the interests of the corporation, and
- (iv) that there was good faith⁶⁶.

This equitable concept, provides the court with a broad discretion to determine whether the director should indeed incur personal liability, but the rule is not a matter of right. For

⁶⁴ Ibid, para h.

⁶⁵ See post Chapter 8.

⁶⁶ Joseph Hinsey IV: "Business Judgement and the American Law Institutes Corporate Governance Project" *George Washington Law Review*, 1984, 52.

instance, in *Norlin Corporation v Rooney, Pace Inc.*⁶⁷, the rule was not used to protect directors who had issued shares to employees, ostensibly as an ESOP or employee benefit programme, but which was in fact done to fight off a take-over bid. The court concluded that despite the large independent element on the Board, the scheme was managerially self-perpetuating. The scheme would however have been viable had the self-interest not been established⁶⁸.

The court's intervention is not to be an everyday occurrence where, in the absence of stockholder approval, the courts become surrogate shareholders. Rather the court's intervention comes where the directors' actions have constituted a breach of trust⁶⁹. The principle has with it the hallmark of American free-market enterprise, as it captures the essence of liberal attitude to entrepreneurialism, which includes allowing for commercial mistake.

It has prompted analysis of its relationship with the duty of care for directors. During the eighties this standard was also objectivised by the Principles proposed in the Model Business Corporation Act. Here, the Standard for the director was that of the 'ordinarily prudent person'. This proposed draft seemed to engender the idea that the business judgement rule was at last being codified. However, the basis of the rule is subjective, looking at the personal characteristics of the director. The result would be a two tier system of care. Under the code, an objective duty, which if breached would not necessarily mean personal liability for the director if he could then go on to show that the business judgement rule applied⁷⁰.

In the case of *Aronson v Lewis*⁷¹, the Delaware Supreme Court concluded that liability under the business judgement rule is predicated upon concepts of gross negligence. The effect of such a rule would allow the British courts to recognise the relevance of S 727 Companies Act 1985 in this scenario. However, in rejecting its application to the area of wrongful trading we

⁶⁷ [1984 Transfer Binder] Fed. Sec. L. Rep (CCH) 91, 564 (2nd Cir June 27, 1984).

⁶⁸ *Southern Public Services Co. v Graniteville*. C.A. No. 83-1028-8 (D.S.C May 19, 1983).

⁶⁹ Justice Louis Brandeis in *Cooper Securities Co. v Amalgamated Cooper Co.*, 244 US 261, 263 (1917).

⁷⁰ *Supra* 65.

see a gap arising between the flexibility of the American system, and the rigidity of judicial intervention in the British system.

Clearly, wrongful trading is designed to inhibit the idea that the director has at all times a '*carte blanche*' to indulge in commercial activity, regardless of the consequences to the shareholder, even if he can show that he gained no personal profit from his trade, and that he acted in good faith. The business judgement rule allows the director to be more cavalier with the company without incurring personal liability. His British counter-part is however, limited when it comes to the question of taking such action to get the company out of financial difficulty, if it necessitates him trading while insolvent.

This is perhaps a broader reflection of the philosophical state of the nations to the question of director management. There is however a strand of opinion within the commercial community in Britain which would no doubt be quite at ease with accepting the more commercially daring principle of the American courts⁷².

For its part, wrongful trading is at present a hallmark of British conservatism in the free market, but this has its problems in trying to stem the ever increasing tide of market openness and free trade spirit.

Judicial Reservation of Wrongful Trading

In the case of *Re Bath Glass*⁷³, two directors were faced with a disqualification order of up to fifteen years, under S 6 of the Company Directors Disqualification Act 1986. The section

⁷¹ 473 A.2d 805, 812 (Del. 1984) .

⁷² See post Chapter 9.

⁷³ [1988] BCLC 329.

provides that where a company is insolvent, the court is under a duty to make an order for a period of not less than two years where :

*"... on the application of the section, it is satisfied (i) that he is or has been a director of a company which has at any time become insolvent (whether while he was a director or subsequently), and (ii) that his conduct as a director of that company (either taken alone or taken together with his conduct as a director of any other company or companies) makes him unfit to be concerned in the management of a company."*⁷⁴

The case involved a company dealing in crafts, in which the directors were also the major shareholders. From June 1981, the company's balance sheet showed that the company was making a loss; that year it was £20,000. By 1982, the liabilities of the company exceeded the assets of the company by £36,000, and by 1983, this resulted in a loss of £60,000 and liabilities exceeding assets by £75,000. This increased to a £120,000 deficit by May 1984 and £158,000 by June of that year.

Throughout this period Midland Bank continued to support the company although, throughout 1985 it did press the company to reduce its borrowing, which it did by some £87,000, albeit at the expense of the Crown in relation to monies owed for VAT, PAYE contributions and national insurance⁷⁵. When the company was compulsorily wound up on 14th July 1986, it had an estimated deficiency regarding creditors of £128,000, including VAT sums of £38,000 for the period of May to December 1985, and PAYE tax and national insurance contributions to the sum of £68,000.

In the judgement, counsel for the Official Receiver, argued that while the directors were not dishonest in terms of committing fraud, there had been some dishonesty in continuing to trade while not telling the creditors of the true position of the company and of not paying the creditors⁷⁶.

⁷⁴ Section 6 (1)(a)(b), Company Directors Disqualification Act 1986.

⁷⁵ Ibid, p 335, paras d and e.

⁷⁶ Ibid, p 338, para a.

During the final years of trading sums of £5,750, £39,000, and £55,200 were paid to the new company called Collective Ltd., by the managers. The sums were justified by the directors as being remuneration, which enabled them to keep a certain standard of living, and also to improve their homes, which were collateral for the monies borrowed from the bank. The judge, Peter Gibson J., stated that this was a criticism, as the directors had not kept the transactions between the companies at arms length⁷⁷.

Nevertheless, when it came to granting the order, Peter Gibson J. refused the Official Receiver's application for the following reasons. Firstly, he stated that the directors had in no way been dishonest, in that they had not benefited themselves at the expense of the company. Secondly, they had shown readiness to make a financial commitment to the company which was to their credit. Thirdly, accounts were always kept, and even if they were inaccurate, they were kept up to date with care and even caution. Fourthly, that the directors' belief that the company would trade out of difficulty was not without any rational foundation. Fifthly they took professional advice, and lastly, that the misfortunes of the company were not within the directors' control. For example, the breakdown of one of the director's marriage, a contraction in the craft market and a problem with one of the ranges of crockery which the company had made⁷⁸.

These defences can be criticised for several reasons. Firstly, on the question of dishonesty, the directors knew that the Inland Revenue had not been paid and yet continued to trade. The excuse the directors gave for non-payment, was that the Crown did not press for payment⁷⁹. Can this really be a good reason for concluding that the directors were not dishonest.?

The court also praised the directors for their account keeping, but there had been occasions where the accounts were submitted late, and, with the judge's admission, were not always accurate. The observation that the company could trade out of its predicament is hard to marry

⁷⁷ Ibid, p 338, paras f and g.

⁷⁸ Ibid, p 339, paras g - i. Also p340, para a.

⁷⁹ Ibid, p 337, para h.

with the fact that throughout the period 1981 to 1986, the company's deficit worsened considerably, as did its profit, and that the report of the Midland Bank in May 1984, opened with the statement that the company was insolvent.

Nevertheless, the directors continued to trade and the decision by the bank to continue its financial help, was taken on the understanding that the company would move into profit by the end of that year. This however was a view misguided by the fact that the bank believed the trading to belong to one company, when in fact the forecast was one for Bath Glass and Collective jointly.

Finally, the judge stated that there were factors which lay outside the control of the directors. This was a challenge to the orthodox position that judge never evaluates the decisions taken by the management⁸⁰. In doing so, the judge opens a debate about the use of the judiciary as a means for establishing a more objective standard of behaviour for directors.

The case is the focus of much debate on this issue,^{81*} because while the judge was prepared to intervene and make the decision that the directors were not unfit, he was not able to invoke the wrongful trading provision at all, despite the fact that there was ample evidence, that even after the advice and opinion of the bank, the two directors continued to trade, while the company was clearly insolvent. This resulted in greater loss to the creditor, in particular the Inland Revenue and Customs and Excise.

The directors believed that their new Christmas collection and 'Dinner at Eight' collection, would genuinely take them out of their otherwise dire position⁸². However, on the facts of the case there was a continued rise in the deficit, warnings from the bank and a decision to ignore payment of considerable sums of money to the public purse. Would this not constitute the sort of behaviour which the Cork Report envisaged the section covering?

⁸⁰ See Parkinson Corporate Power and Responsibility, Chapter 4, p105-109 ante.

⁸¹ See post Chapter 4.

⁸² Supra 8, p 336, paras b and c.

There are several explanations as to why the provision was not used in this case. Section 214 has itself a disqualification provision which is to be found in S 10 of the Company Directors Disqualification Act 1986. Under that section, the court, upon making a declaration under S. 213 or 214 of the Insolvency Act, may consider "whether an application for such an order is made by any person,...also make a disqualification order against the person to whom the declaration relates."⁸³

The major difference between the court's discretion under this section and S 6 of the Act, is that at no time can the court take into consideration the directors' performance in a company, other than that of the company in which he has wrongfully traded. If Peter Gibson J., had on the facts of this case, used the wrongful trading provision, he would have been faced with the almost inevitable decision of disqualifying the directors. They were considerably in debt and much of this had been due to their dishonest decision not to pay the Inland Revenue.

In making an analogy with those cases in which a successful claim of wrongful trading was brought, it is difficult to avoid perceiving a policy reason for an absence of the provision in the present case. The directors of *Re Bath Glass*, had established another company, Collective, which was trading successfully and a source of employment. To utilise a disqualification provision, which was not sensitive to this fact, would be to undermine the successful company by disqualifying its directors.

Section 6, however, has the dimension to look at the director's performance in other companies and decide on that broader base whether to disqualify. Thus, judicial interpretation of the provision was in this case deferential to the economic expediency of the commercial world. The judicial sensitivity to this matter which contains that element of socio-moral expectation to which corporate managers are subject as the commercial world relies increasingly on the public for financial input, can be justified in that too draconian a measure, illustrated in the

⁸³ Section 10(1), Company Directors Disqualification Act 1986.

effects of S 214, and the disqualification provision of S 10, fetters that growth in enterprise which is the desire of the vast majority⁸⁴.

The cost of the action would for the same reason, make the provision less attractive as a means for gaining redress against the directors. Based on 1991 figures it is suggested that between £30,000 and £50,000 are needed to bring a successful claim, where the evidence is clear, and the case is therefore straightforward⁸⁵. As costs are usually awarded against the defeated defendant, the two directors in *Re Bath Glass*, would have been faced with a considerable bill, which would not only damage their own capital, but also the capital of the new company which was trading successfully.

Whether costs would be universally so high is unclear. What the case does illustrate is that it is a real inhibition to the use of the provision. Peter Sergeant writing about a case in which he was representing a group of creditors⁸⁶ made the following comments:

"Wrongful trading actions do not have to be taken in only larger cases; it can be successfully applied to smaller matters. What it does require is the courage, determination and willingness of the liquidator and his solicitor alike to carry the matter through to a successful conclusion despite the paucity of the available assets."

In this particular case, a husband and wife team had incorporated their business, running a tour operating company. The directors had been using customer's money to fund the company's working capital from the very beginning and had never operated a separate customer deposit account. The company never made a profit and was eventually wound up just over three years after its incorporation. The directors were ordered to pay £7,000 to the liquidator pursuant to proceedings under S 214, despite the fact one of them was unemployed⁸⁷.

⁸⁴ Supra 40, and Chapter 1.

⁸⁵ Figures from Report by Christina Williams and Professor Andrew Mcgee for the Chartered Association of Certified Accountants. LONDON 1992.

⁸⁶ *ibid* at p 15. Fairmont Tours (Yorkshire) Ltd. (unreported), Insolvency Law and Intelligence (1990).

⁸⁷ Supra 43, Chapter 4.

One of the factors which led to the provision being so forcefully used in this case was the fact that a number of those who were affected by the directors' action, were old age pensioners who had paid money to the company and had lost out. It was the determination of the liquidator and the solicitor in this case to pursue the directors for compensation, which was the source of the success. This seems to be a rare move for a liquidator in circumstances where there is no large fighting fund nor assets to cover his costs in getting a case off the ground.

The motive behind the creditor is an important factor as to whether a case is brought at all. In this particular case, there was a feeling amongst those who had lost out as a result of the directors' actions, to make them pay for what they had done. This gives further strength to the argument that the provision is punitive in nature⁸⁸.

The paucity of case law, while indicating a dissatisfaction of the use of the provision, does illustrate some of the problems which the judiciary has faced generally in making decisions involving commercial judgements. In the next chapter, there will be an exploration of the problems faced by the judiciary and the Department of Trade and Industry, in the implementation of wrongful trading, and in particular the use of disqualification as an effective policing measure in the company.

The Position of the Shadow Director

Commentary on the interpretation of the shadow director's liability for wrongful trading, which is found in S 214(7) Insolvency Act 1986 only serves to buttress the general view of the judiciary's reservations in interpreting the concept of wrongful trading.

The importance of whom the courts have perceived as a shadow director is central to the section's effectiveness to act as an assessable measure which will produce a result. This is

because often, the institution which will be under scrutiny as a potential shadow director in law is a bank with a considerable pocket and great influence over the destiny of many corporations.

Two cases which illustrate judicial reservation in this particular aspect of the section are *Re Hydrodan (Corby) Ltd.*⁸⁹ and *Re PFTZM*⁹⁰.

The first case involved the liquidation proceedings of *Re Hydrodan (Corby) Ltd.*, a wholly owned subsidiary of Eagle Trust plc. The defendants were directors of Eagle Trust and sought to strike out the liquidators application for liability for wrongful trading on the basis that neither of the men were in fact directors or shadow directors of the subsidiary.

Millet J. defined three different types of corporate directors. First, in law, directors (validly appointed); second, *de facto* directors (those who assume to act as directors without valid appointment) and shadow directors (within the meaning of S 251 of the Insolvency Act 1986). While the judge was prepared to include all of the categories in the ambit of liability, pointing to the fact that the responsibility of directorship and not the validity of the appointment was the issue, he did stress the need to distinguish between the different types of directors when bringing a claim. Here, the liquidator had not distinguished between the concept of shadow and *de facto* a director⁹¹.

In order to prove that someone was a *de facto* director all that was necessary to show was the person had acted as a director. However to prove that someone was a shadow director, it was necessary to show: firstly, who the corporate directors were (either *de jure* or *de facto*); secondly, that the defendant directed those directors how to act or that he was one of the persons that did so; and, thirdly, that those directors acted in accordance with such

⁸⁸ See Chapter 1.

⁸⁹ (1994) BCC 161.

⁹⁰ [1995] BCC 280.

⁹¹ *Supra* 89, p 163, para c.

instructions and were accustomed so to act on those instructions. The emphasis of the judge was clearly that shadow directors “...lurk in the shadows” and are not directors at all⁹².

Millet’s J. interpretation of the term “directors who are accustomed to act” was displayed as meaning the whole board and not individual directors of the corporation⁹³. Thus, on the facts of the present case, it was correct to assume that the parent company Eagle Trust was a shadow director, but the individual directors who made up the company, were not shadow directors. This was due to the fact that they did no more than was expected of a director in the holding company; to attend meetings, and to vote. For Millet J., the directors’ duties were to Eagle Trust and not to the subsidiary. As a result, the liquidator’s claim for wrongful trading was struck out⁹⁴.

In *Re PFTZM*, a company which ran a hotel and country club refinanced loans to H, a group of bankers for the sum of £6.75 million. It was agreed that apart from the security of the lease on the buildings, the bankers would be entitled to weekly meetings concerning the company’s performance. These meetings were held for two years until the company went into liquidation. The liquidator brought *ex parte* claims against the plaintiffs (H) after they refused to answer a second questionnaire which they thought was oppressive. The liquidator sought an action for wrongful trading.

In his judgement, Judge Sir Paul Baker QC, made a number of observations concluding that the bank was not a shadow director⁹⁵. The judge considered the powers of the bank as a secured creditor. The bank could take steps to recover its investment; it could give the borrower time to breathe; and it could choose to honour one cheque and not another. All this

⁹² Ibid, p 163, para e and f.

⁹³ “Shadow Directorship - a Real or Imagined Threat to Banks”, *Insolvency Practitioner* (1991), p 14-15.

⁹⁴ The distinction here is important, as the *de jure* directors of the parent corporation were not *de facto* directors of the subsidiary (and thus exonerated). The parent corporation was not a shadow director thus not falling within the category of those liable for wrongful trading.

⁹⁵ *Supra* 86 , p 290.

however, could be seen as a display of the bank's objective of protecting its interest as a secured creditor and did not change the bank into a shadow director⁹⁶.

Importantly, the bank's actions were merely terms on which their finance would continue, it was up to the company whether or not to accept those terms and thus it was within the ambit of the company to direct without any direct help from the bank. The liquidator's claim failed therefore and the plaintiff's costs were paid.

The cases signal a lack of threat to the banks, but the cases also open a debate as to how independent the directors of the company have to remain from the bank's influence, before the banks are also included as a de facto or a shadow director. Provided that the company is allowed to make up its own mind whether to continue trading or go into liquidation, then the bank will not be a shadow director. This draws a fine distinction between a company who has no option but to go into liquidation on the advice of the bank, and one that chooses itself to go into liquidation. The important issue is that the company must take the decision itself regardless of how influential the advice is from others⁹⁷.

The cases also show the need for further legal clarity on what constitutes the definition of the term director. The position under S 741(2) Companies Act 1985, is that a parent company will not be a shadow director of its subsidiary just because the subsidiary's directors are accustomed to act in accordance with its directions or instructions. Section 251 of the Insolvency Act 1986 does not include this caveat, nevertheless, the judiciary seems to have implemented one. The net result is that while statute law may have tried to broaden the ambit of the directorial net for determining liability, the courts have tightened the rope.

⁹⁶ Ibid, p 291.

⁹⁷ Gautam Bhattacharyya, *Re Hydrodan (Corby) Ltd 'Shadow Directors and wrongful trading'*, *The Company Lawyer*, Vol. 15, no. 5, 1994.

Clearly, the scenarios indicate that the liquidator should be very careful when alleging wrongful trading against a director⁹⁸. This is particularly so in relation to the fact that the cost to the liquidator may result in even fewer assets being available to turn into money for the creditors. This was the case in *Re Hydrodan*.

The courts have prioritised the importance of the different contractual groups which make up the corporate nexus and to which company law constantly tries to strike a fair balance. The cases show that the banks as creditors will not be inhibited from lending money, on the basis that monitoring that loan may result in a claim for wrongful trading. It also allows for the bank to make offers to the company to suggest that the company remains as a going concern, again with the objective of freeing the banks from the threat of wrongful trading.

For the concept of wrongful trading itself, the cases illustrate a reluctance to use wrongful trading, perhaps because there are other policy reasons for narrowing its scope. The draconian consequences, applied to the concept have prompted the courts to understate the provision.

While this judicial reluctance to use the concept may be expedient to the commercial community, it does undermine further the intention of the 1986 legislation. This is to get tough on those directors who play with company assets, and who fall short of the objectively perceived standard of directorial behaviour, for which S 214 Insolvency Act has been held to be a statutory definition⁹⁹. This compromises the hope that the new concept of wrongful trading would lead to broadening the duty of the director in a 'professional' capacity. This has created an idiosyncratic history for the position of the director, as the role of insolvency law has become an important aspect of the general development of directors' duties.

⁹⁸ See inter alia Gautam Bhattacharyya, Shadow Directors and wrongful trading revisited 1995. *The Company Lawyer*, Vol. 16, no. 10, p 313.

⁹⁹ *Supra* 61.

CHAPTER 4

DISQUALIFICATION OF DIRECTORS AND THE INSOLVENCY SERVICE

An important aspect of director policing is the threat of disqualification, which will deprive the director not only of his current ability to act in a commercial enterprise, but will have the added burden of restricting his activities for sometime into the future. The objective of this chapter is to illustrate how effective this aspect of director policing is and also how effective the idea of disqualification is in attempting to raise the standards of the director's performance by acting as a threat to the director's livelihood.

Powers to disqualify were vested in the courts as a result of the recommendations of the Departmental Committee on the Companies Acts in 1925, which led to the implementation of ss 217 and 275 Companies Act 1928 re-enacted in the Companies Act 1948, ss 187 and 188¹. The sections dealt largely with undischarged bankrupts acting as directors and with persons who had been convicted of fraud being involved in the management of a company.

These provisions were extended and toughened by the Companies Act 1976, extending the maximum disqualification period to 15 years for cases of fraud, and providing for the first time a register of disqualification orders. These provisions were further strengthened in the Insolvency Act 1985. Under this Act, it was possible to disqualify a director for an unlimited period, if he were to be found unfit to be a director, after one company failure².

¹ L H Leigh (1986), 7 Company Lawyer, 179.

² Insolvency Act 1985, S 12 (1) as amended by section 8 Company Directors Disqualification Act 1986. For a complete overview of the provisions, see post.

Under s28 (1) of the Companies Act 1976, an extra power was given for "persistent default" of the Act. As Nourse J. reflected in *Re Civica Investments Ltd.*³ the first application of this provision was not made until 1980⁴, and by the time this case had been brought to court, only four previous cases had been heard⁵.

As a result of this section, the court was able to make a disqualification order for up to five years where a person had persistently been in default in relation to:

*"Any provision of the Companies Acts which require any return, account, or other document to be filed with, delivered or sent, or notice of any matter to be given, to the registrar of companies."*⁶

From 15 June 1982, s28 was replaced by an amendment to s188 of the 1948 Companies Act made by s3 of the Companies Act 1981. This extended the power to make disqualification orders to cover liquidators, receivers and managers of the property of the company. At first, these powers were used cautiously⁷ with reference to their use being in the context of the defendants having a previous conviction in the magistrate's court for default and continuing defaults thereafter. Such caution was not obligatory however under the terms of the section⁸.

The provisions were strengthened in the Companies Act 1985 s 300, where a director could be disqualified if his unfitness was illustrated through him being connected with two successive insolvent companies. This was tightened in subsequent legislation, to one failure⁹. Thus The Company Directors Disqualification Act 1986 (CDDA), represents an attempt by the legislature to not only toughen the provisions relating to disqualification, but also to make them easier to discern by the lawyer¹⁰.

³ [1983] BCLC 456.

⁴ *ibid*, Nourse J., p 457.

⁵ *ibid*.

⁶ *ibid*, p 458.

⁷ *ibid*, p 459-460. Indeed in his summing up of the case Nourse was prepared to be on the lenient side with the director, giving him a one year ban from being a director because he had sought to put right the wrongs which had been done as a result of his incompetence.

⁸ "The Disqualification of Directors" Dine (1988), 9 Company Lawyer, 213.

⁹ *Supra* 2.

¹⁰ Thus a conviction of an indictable offence in connection with a company under S 296 Companies Act 1985, became s2 CDDA 1986, and remedies for persistent default of companies legislation formerly in S 297 Companies Act 1985, were to become S 3 CDDA.

In spite of these far reaching measures, disqualification of directors was not frequently employed by the Department of Trade and Industry. The most compelling reason for this was the restricted number of individuals who could actually bring an order against a director, as only the Secretary of State or an Official Receiver nominated by him, could make an application. Also liquidators of companies were often disinclined to disclose knowledge of directors wrongdoing to the authorities even though they were under a statutory duty to do so¹¹. This inaction was the major consequence of the laissez-faire approach to industry which was the hallmark of the corporate policing institutions in the early eighties¹².

However, with the passing of the Insolvency Act 1986, and the Company Directors Disqualification Act 1986, it was hoped that some of the more phlegmatic elements of corporate policing would be eroded and the threat of disqualification be a more effective measure in regaining director deference to the statutory provisions relating to amongst other matters, returns of accounts and fitness to direct¹³.

The provisions, including section 6 of the CDDA, reduced the need to show mismanagement in two successive company insolvencies, and that the directors conduct would be judged on the facts of the current insolvency, although his activities, positive or negative, in other companies would be taken into consideration when making a disqualification order¹⁴.

Only S 300 relating to unfitness discernible by two involvements with successive company failures within 5 years was dropped for a tougher regime (see *supra* 2).

¹¹ *Supra* 2, S 12(a) and S 632(3) Companies Act 1985.

¹² This inaction led to the reforms of 1986, with their reactionary approach to the problem of insolvency abuse by directors. See *ante* Chapters 2 & 3.

¹³ See The Cork Report 1982, para 1818.

¹⁴ See S 6 (1)(b). At S 6(2), the breadth of the section was illustrated by the broad definition of the term insolvent company, which is a prerequisite to the order being made. Apart from the balance sheet definition at section 6(2)(a), the company is also deemed to be insolvent when an administration order has been granted (S 6(2)(b)) and when an administrative receiver is appointed (S 6(c)). In contrast, S 8 CDDA, requires an investigation to have taken place for a disqualification order to be granted for unfitness. But here, the broader notion of disqualifying in the interest of the public is at the court's discretion.

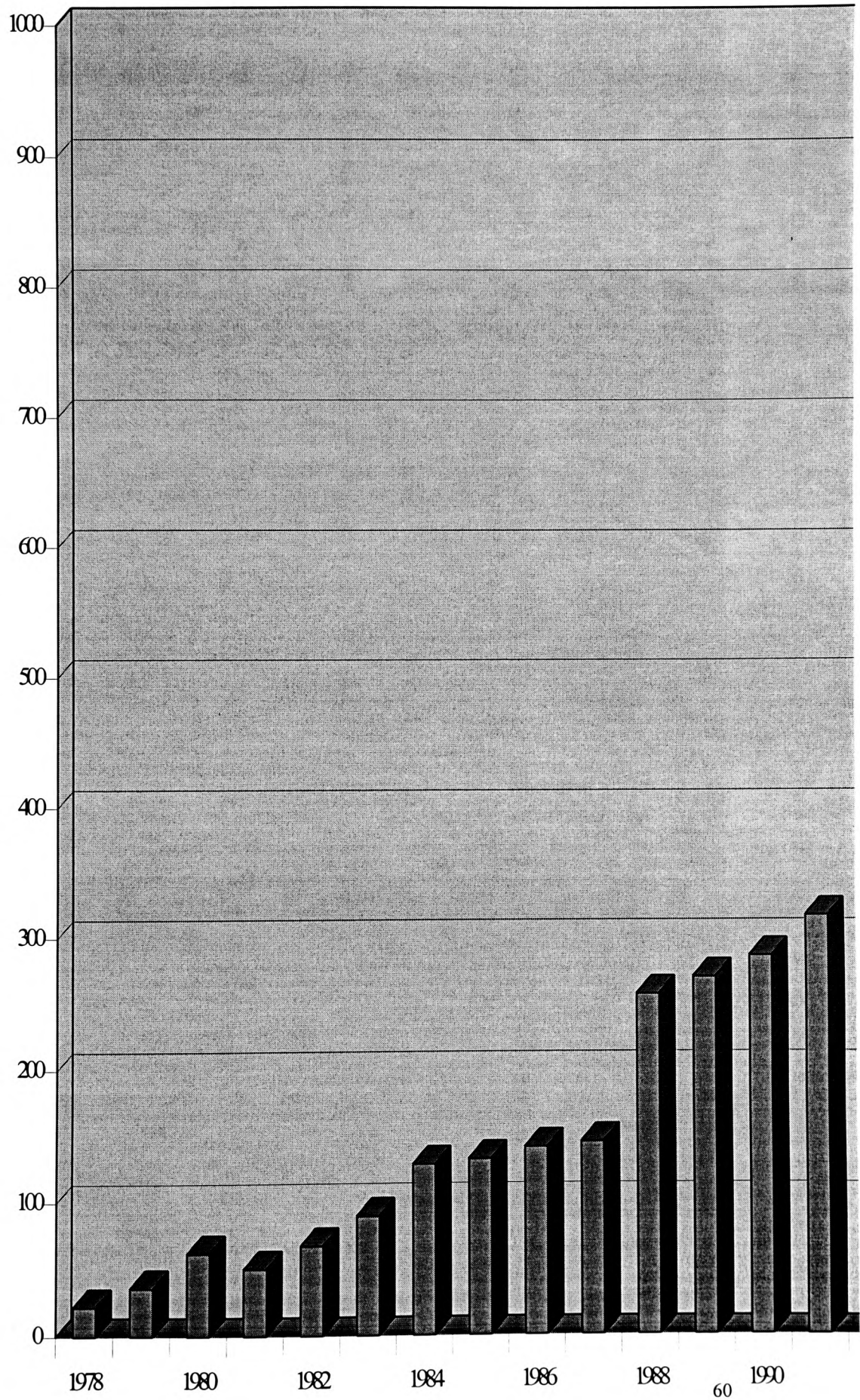
Disqualification of Directors and the Insolvency Service

Throughout the latter part of the eighties there was a rise in the use of the disqualification orders which suggested that the traditional approach taken by liquidators was under threat. The following table shows the number of disqualification orders made before and after the advent of the 1986 insolvency legislation.

Disqualification Figures for 1978-1996¹⁵:

¹⁵ See Annual Reports of the Insolvency Service 1978-1996, published by the DTI. During the latter part of 1996, the Insolvency Service issued proceedings against 352 directors 20% more than the previous year. DTI Press Notice No. P/97/162, 24.2.97. Business Law Review (April 1997).

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This increase shows that the Department of Trade and Industry realised that direct intervention to disqualify directors is a more effective policing measure than penalising the company with a fine in the hope that the shareholders will then bring an action against the directors to dismiss him¹⁶. The profit motive, traditionally central to the shareholder, will make them reticent to get rid of the corporate managers¹⁷.

¹⁶ S 303 Companies Act 1986. This section has been eroded in its effectiveness by the wide based share ownership and the gap of that ownership with corporate control.

¹⁷ See post Chapter 5, particularly focusing on the reasons for shareholder reticence in utilising their common law and statutory powers within corporate management.

The Insolvency Service

The Insolvency Service is an Executive Agency of the DTI, and is designed to create confidence in the market by providing the means of dealing with individual and corporate financial failure and tackling fraud and wrong-doing in insolvencies¹⁸. It principally operates under the Insolvency Act 1986, The CDDA 1986 and the Companies Act 1985. Its principal functions are numerous:

- i) the preliminary administration and investigation of compulsory insolvencies (bankruptcies and companies, including partnerships, wound-up by the courts) and acting as interim receiver and provisional liquidator in appropriate cases
- ii) to report criminal offences in compulsory insolvencies and taking disqualification proceedings against unfit directors of failed companies (including Scotland)
- iii) to act as trustee or liquidator in compulsory insolvencies where no private sector insolvency practitioner is appointed
- iv) to authorise and regulate, directly or through recognised professional bodies, of private sector insolvency practitioners (including Scotland)
- v) to provide banking and investment services for bankruptcies and liquidations
- vi) to provide advice to Ministers on insolvency issues (including corporate insolvency in Scotland)
- vii) to operate the IS accounts.

With such a broad spectra of responsibilities, the Insolvency Service stands at the centre of issues relating to more than just the winding-up or rescuing of the company, and has the

¹⁸ The Insolvency Service Annual Report 1992-1993: Introduction and Summary.

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responsibility for determining factual situations which will result in a successful disqualification of directors and other office holders who have breached their duties and who have mismanaged company affairs.

It is this element of the Service's responsibility which is affected most by the way the courts have chosen to interpret that legislation which currently provides the Service with ammunition to curtail managerial fraud and negligence. An inconsistent approach by the courts would inevitably lead to uncertainty in the Service about the success of a potential order being sought.

The Insolvency Service along with the DTI's Investigation Division, provide the epicentre of evidence building for successful claims against directors. Other bodies which aid in this are the Serious Fraud Office, the Securities and Investment Board, the Crown Prosecution Service and the Police Force, as well as the regulatory bodies on the Stock Exchange.

The relationship between the courts and these bodies has been an important factor in the effectiveness of the service as a policing measure¹⁹. The legislation of 1986, intended to provide more stringent standards for corporate managers, increasing the penalties for mismanagement, particularly where the company is in financial difficulty.

However, the courts have taken a flexible approach to the use of disqualification orders in fulfilling this objective. Under section 17 of the Company Directors Disqualification Act 1986, it is possible for a director who is disqualified to apply to the courts for leave to be reinstated. The courts have seized upon this waiving provision as a method for exonerating company directors from disqualification, not just at a stage later on in their disqualification, but earlier, when the initial decision to disqualify is being made²⁰.

¹⁹ See "Investigations - How They Work", DTI, 1993. In particular, the responsibilities given to the different bodies so that there is no overlap in their investigation processes.

The Effect of Case Law

The judicial journey in making the CDDA an integral aspect of commerce's attitude to and expectation of director activity, has produced certain criteria which balances both the need to set standards of commercial integrity while at the same time allowing for directors not to feel too inhibited by any draconian legal consequences to the inherent characteristic of risk in their responsibilities.

The legacy of *Re Bath Glass*²¹ was illustrated in *Re Matthews*²². Here Peter Gibson J. again exercised wide discretion in deciding the fate of the director. The case was brought under the old rules in the Companies Act 1985 (section 295 and Pt 1 of schedule 12). Here, a director who conceded that his conduct in two failed limited liability companies was unsatisfactory, argued that he had learned his lesson and that the public had no need to fear from his management in a third company which was successful.

Peter Gibson J., while not accepting this argument as justifying the exemption from a disqualification order, did remark that an application for reinstatement as a company manager would be viewed with sympathy if the defendant continued to trade in an unlimited liability company²³.

A more liberal approach was taken by Mervyn Davies J in *Re Majestic Recording Studios Ltd.*²⁴. Here, a director was able to continue trading as long as he remained subject to the auspices of an independent accountant and to submit audited accounts by a specified date. A significant factor in the judge's decision was the need to protect the 50 or so employees of the second company. The imposition of a third party to oversee the actions of the director, was

²⁰ See cases below and inter alia, "Partial Disqualification Orders", David Milman, 1991, *The Company Lawyer*, Vol. 12, No.11.

²¹ [1987] Ch 329, *Supra* Chapter 3.

²² (1988) BCC 513.

²³ *ibid*, p 518.

²⁴ [1989] BCLC 1.

allowed in *Re Lo-Line Electric Motors Ltd.*²⁵. Here a named person, a qualified accountant, also remained a director of the company, and the controlling voting share was to remain with the family.

The above cases were decided under the former rules relating to disqualification which were to be found in s 300 of the Companies Act 1985. The predilection of the judiciary to be flexible in the decision to disqualify directors carried forward into the subsequent legislation relating to disqualification. In *Re Chandos Ltd.*²⁶, a director of a company that was undercapitalised and that had failed to produce proper accounts was allowed to continue as a director of a successful company as long as he held monthly board meetings in which the company's auditors would be present. This arrangement was for a trial period of one year, but the judge allowed for a fresh application to be made by the defendant at the end of that period.

These cases illustrate the judiciary's objective of trying to weigh what is often the conflicting interests of commercial functionalism with the need to protect the public from the corporate managers who utilise their position for their own personal gain. The balance between encouraging enterprise and protecting the consumer and creditor is a fine one and the judges have displayed caution in developing the concept of a partial disqualification order²⁷.

This objective is complicated by the equivocal ambit of the provisions of the Company Directors Disqualification Act (CDDA) 1986. The standard of behaviour which warrants a disqualification order, gives the court the same degree of difficulty in defining the underlying objective of the provisions as it faced when implementing the then new provision of wrongful trading, after the 1986 legislation²⁸.

The most frequently employed section of the CDDA 1986 is section 6 relating to the disqualification of directors for unfitness. The Act contains criteria for the courts to use in

²⁵ [1988] 3 WLR 26.

²⁶ [1990] BCLC 673.

²⁷ David Milman, 1991, *The Company Lawyer*, 224 - *supra* 18.

deciding that a director is unfit. Under section 9 and Schedule 1 part I of the Act, a director will be disqualified if he has committed a misfeasance in his fiduciary position, in relation to the company²⁹, has retained monies³⁰, has entered into preference agreements³¹, has failed to comply with the administrative provisions of the Companies Act relating to company administration, and finally has failure to make annual returns or make annual accounts³².

Under Part II of the Schedule, there are further matters which relate to insolvency only. These include the responsibility of the director in the company becoming insolvent³³, the responsibility of the director in failing to supply goods which have already been paid for³⁴, the director's responsibility for entering into a preference³⁵, a failure on behalf of the directors to call a creditor's meeting in compliance with section 98 of the Insolvency Act, as well as a failure on behalf of the director to comply with those aspects of the Insolvency Act which relate to the winding-up of the company, including providing a statement of affairs, and cooperating with the liquidator³⁶.

In order to establish whether the courts have been able to employ an objective standard to the cases involving disqualification, it is first necessary to analyse the evolution of the disqualification order.

The philosophy underlying the disqualification provisions, reflects the changing attitude of the courts to the objective of disqualification. The position was unequivocally stated by Bramwell L. J. in *Mellor v Denham*³⁷, commenting on whether a disqualification order was a criminal or civil consequence. He said :

²⁸ Supra, Chapter 2.

²⁹ Schedule 1, pt 1(1).

³⁰ *ibid* (2).

³¹ *ibid* (3).

³² *ibid* (4).

³³ Schedule 1, pt 2(6).

³⁴ *ibid* (7).

³⁵ *ibid* (8).

³⁶ *ibid* (9) & (10).

"...it is clear to my mind that the matter complained of is in truth a criminal offence...."

This statement reflects the criminal/quasi-criminal nature of the disqualification order which has resulted in the courts finding mitigating factors within the civil legislation relating to director disqualification, which clearly have a penal or had criminal characteristic to them. This in turn detracts from the underlying philosophy of civil law which is protect the consumer, without reference to the consequences for the director.

In the case of *Green v Green* ³⁸, the appellants pleaded guilty to carrying on a business with the intent to defraud creditors, contrary to the Companies Act 1948 section 332(3) which had resulted in a suspended prison sentence, a fine and disqualification. On appeal, the sentence and the fine were quashed as was the disqualification order. No distinction was made between the fine and imprisonment (which clearly involve punishment) and the disqualification order. The same factors were regarded as mitigating or aggravating in respect of each possible outcome³⁹.

The argument for the nature of disqualification to be placed in a criminal context was given further credibility in *Re Gilgate Properties Ltd.* ⁴⁰. Here, the judge, Sir Robert Megarry VC heard three originating summonses on the basis that the directors of the company had been "persistently in default in relation to relevant requirements of the Companies Act" (s28 of the Companies Act 1976). Counsel for the defence argued that the introduction of evidence about the former misconduct which showed a failure to comply with the Companies Act, was analogous to the effect of adducing previous convictions in criminal law.

The judge while arguing that this analogy was far from perfect, did conclude that there were grounds for accepting that former misconduct whether charged separately or not, could be relevant in illustrating the sophistication of the director's activities in avoiding the provisions

³⁷ (1880) 5 QBD 467.

³⁸ (1981) 3 Cr App Rep.

³⁹ Supra 11.

which led to a s28 charge being successfully brought against him. In doing so he gives the provision an unequivocal message, that disqualification is indeed punishment⁴¹.

The quasi criminal nature of the disqualification provision will effect the judge's conclusion that the case has been sufficiently well evidenced against the director. The more serious the consequence of the actions, the more burdensome it is for the petitioner to prove his case. The extension of the civil burden of proof was recently illustrated in the case of *Re Living Images*⁴² when, on making a disqualification order of six years, the judge was not prepared to allow grounds for disqualification where a transfer of unprofitable business was made to the company and was held by the petitioner not to be in the best interests of the company. The case shows that something beyond commercial misjudgement is to be shown before the disqualification order is made; trading while insolvent and depriving the company of profitable business were two such criteria.

The theme of punishment is reflected further in *R v Kazmi*⁴³. Here disqualification was mentioned as a criminal penalty with the objective of a deterrent. In *Re Stanford Services*⁴⁴ Vinelott J. stated that the consequences faced by the director reflected the:

"Serious breaches of obligation as a director, which for the public interest resulted in an order of disqualification."

The case law does not reveal any consistency, but instead reflects the ambiguity of judicial reasoning which pervades the area of corporate governance. In *R v Russen*⁴⁵, Lord Lane CJ stated that the "primary object of disqualification is to protect the public". What was important in this case which involves revenue debts was that the judge saw no direct harm to the public. This reasoning is somewhat compromised if the broader view of not contributing to the public purse is reflected in public services being cut.

⁴⁰ Ch 13:3:1981. (unreported).

⁴¹ Supra 11.

⁴² [1996] 1 BCLC 348.

⁴³ (1984) 7 Cr App 115.

⁴⁴ [1987] BCLC 607.

The diversity of reasons for the disqualification order to be implemented is further highlighted in the actual grounds for disqualification itself. Discerning a sufficient mental element for disqualification has left the courts with several options. Under s6 of the CDDA, the question of unfitness has initiated three standards, the compromise of which will lead to a disqualification order being granted.

First, a disqualification order will be granted if there has been a "disregard for commercial morality". In *Re Dawson Print Group Ltd.* ⁴⁶, Hoffmann J. refused to grant a disqualification order because the case had failed to show the requisite need that:

"some conduct in breach of standards of commercial morality or some gross incompetence which persuaded the court it would be a danger to the public if he was allowed to be involved in the affairs of the company."

In this case a disqualification order was refused under section 300 of the Companies Act 1985, where a director had been involved in two companies which had been compulsorily wound up owing money to the Crown in the form of PAYE, NIC and VAT. In *Re Bath Glass* ⁴⁷, the incompetence and imprudence of the directors was not enough to justify a disqualification order as Peter Gibson J. stated that:

"To reach a finding of unfitness the court had to be satisfied that the director had been guilty of a serious failure or series of failures, whether deliberately or through incompetence, to perform those duties of directors which were attendant on the privilege of trading through limited liability companies."

This conclusion was reached despite the fact that the company was insolvent owing the public purse £128,000, while there was clear evidence that the directors had ignored constant advice from banks that the company was insolvent⁴⁸. The issue of a greater culpability attaching to debts owed to the crown have taken a more positive course in subsequent cases, such as *Re*

⁴⁵ Court of Appeal (Criminal Division) 6 July 1984, transcript from Lexis.

⁴⁶ (1987) BCLC 601.

⁴⁷ Supra Chapter 3 at 32,

⁴⁸ See case in Chapter 3

Pamstock Ltd. ⁴⁹. Here, Vinelott J. made an issue of the fact that crown debts had gone unpaid, but the case is unusual in that the activities of the director concerned were being focused on over a period of fifteen years and thus the protracted nature of his bad conduct was important.

In *Re Lo-Line Electric Motors Ltd.* ⁵⁰, again brought under section 300 of the Companies Act 1985, Browne-Wilkinson VC said that commercially culpable conduct would be a ground for finding unfitness, which contrasted with mere mismanagement which he said would not constitute unfitness⁵¹.

In *Re Ipcon Fashions Ltd.* ⁵², Hoffman J. spoke of the directors' activities as displaying:

"a certain cunning in dealing with his suppliers and disposing of assets."

In that case the director started to trade in another company while winding-up the first. The judge had no hesitation in disqualifying the director for five years. In the case, the moral overtone of the condemnation of the director by the judge, displays the penal nature of the legislation which the judge felt was appropriate to comment upon⁵³. The hallmarks of "Phoenix Syndrome" were undoubtedly an important factor in the decision as this was one of the major reasons why the legislation was initiated in 1986. It was the cynical use of limited liability rather than any personal dishonesty in that case which prompted the disqualification order⁵⁴. The court does leave in doubt whether the reasoning was entirely protective in nature. Ipcon was clearly another case involving impropriety and this is illustrated in the use of the term "commercial morality".

⁴⁹ [1994] 1 BCLC 791.

⁵⁰ (1988) BCLC 698.

⁵¹ McNulty's Interchange Ltd. [1989] BCLC 709.

⁵² (1989) 5 BCC 733.

⁵³ Vanessa Finch, 1990, 53 Modern Law Review, 385.

⁵⁴ Re Douglas Construction Services Ltd., [1988] 4 BCC 553, 557.

The second reason for implementing a decision that the director is unfit, is on the basis of "reckless mismanagement", which occurs regardless to whether the company has the ability to pay its debts. In *Re Stanford Services*⁵⁵, the Official Receiver placed emphasis on the fact that the directors continued to trade while effectively insolvent. This showed that the director was in sufficient breach of duty in not keeping himself informed of the company's financial position, and as a result was liable to be deemed unfit even though the actual practice of not keeping sufficient monies by to pay public taxes was not in itself a breach of commercial morality⁵⁶.

The case of *Re C U Fittings Ltd*⁵⁷, distinguished the most morally culpable reason for disqualification, that of breach of commercial morality, with the director who simply made a bad commercial decision. The concept of reckless mismanagement, was in this case considered as being the product of the directors being "immersed in the day to day task of trying to keep their business afloat" so that they could not be expected to possess "wholly dispassionate minds" regarding the likely demise of their companies. They tended to:

*'cling to hope'*⁵⁸

This quote from Hoffmann J. seems to permit a rather cavalier ethos to the actions of the director justifying it in the name of commercial enterprise. This remains so even to the point where it begins reflecting a sentimental part of the director's activity; the very thing which the legislation of 1986 was meant to combat. If therefore the error of judgement was for the right reason, the director can feel safe from any disqualification ramifications, but that does not mean that he will always be free to do what he pleases. The judgement does not indicate that

⁵⁵ Post 67.

⁵⁶ The inability to keep informed as to the current state of company accounts was a reason for a two year disqualification against a director in the case of *Re Hitco 2000 Ltd.* [1995] 2 BCLC 63.

⁵⁷ (1989) 5 BCC 210.

⁵⁸ *ibid* at p 214

the court will take a protectionist view of stakeholder interests when creating a legal remit for directors' duties, and thus does not comply with the general aspirations of the Cork Report⁵⁹.

The third reason for being deemed unfit is that of "gross incompetence". In *Re Rolus Properties Ltd.*⁶⁰, Harman J. stated that the lack of knowledge displayed by the director in relation to those administrative aspects of company law relating to the keeping of books were relevant for the purpose of determining unfitness⁶¹.

This case perhaps indicates that placing the requisite level of intention too low in determining disqualification, would discourage entrepreneurs. As Harman J. recognised,

*"The purpose and great value of the invention of 1862 and of the limited liability company was to enable the entrepreneurs to take risks without bankrupting themselves"*⁶².

Against this argument is the fact that in these circumstances only truly incompetent entrepreneurs would be discouraged and that that is a small price to pay for exacting a greater degree of commercial integrity in the market.

These cases do not provide an exhaustive list for determining unfitness. The Company Directors Disqualification Act 1986 itself gives a comprehensive list of matters to be taken into consideration when determining unfitness. In Schedule 1 part 1, a list of matters concerning all companies is given. These include any misfeasance or breach of fiduciary duty, the misapplication or retention of money, by the director, and the failure of the director to comply with those administrative provisions of the Companies Act, for example, section 221 (failing to keep accounting records).⁶³

⁵⁹ Insolvency Law and Practice: Report of the Review Committee, Cmnd 8558, Chapter 44, para 1777/

⁶⁰ (1988) BCC 446.

⁶¹ Francis Fitzpatrick, 1992, 142 New Law Journal 596.

⁶² *Supra* 46, p 557.

Part 2 of Schedule 1 deals with those matters which are relevant to companies which have gone into liquidation⁶⁴. This section reflects on the director's responsibility for the company becoming insolvent, and a failure by the director to comply with those administrative aspects of the Insolvency Act which deal with the director assisting the administration of the company's winding-up, for example, section 235 (the duty to co-operate with the liquidator).

While comprehensive, this schedule does not provide an exhaustive list of factors for determining disqualification⁶⁵. The attitude of the directors to 'Crown' debts has proved to be a significant factor in determining whether a director is to be deemed unfit. The lack of payment of Crown debts, has led to the courts taking a tougher line with directors. In *Re Churchill Hotel (Plymouth) Ltd.*⁶⁶, the courts seemed to follow the rule laid down in *Re Stanford Services*⁶⁷, that monies used as working capital which should have been used to pay crown debts was a significant factor in determining the unfitness of the director. However, this was not followed in the case of *Re Dawson Print Group*⁶⁸.

The amount of the outstanding debt, and in particular Crown debt was the important issue in *Re Lo-Line Electric Motors Ltd.*⁶⁹, while issues as diverse as the age and experience of the director may mitigate the disqualification⁷⁰. These differing degrees of behavioural justification for initiating the disqualification order have led to judicial uncertainty in a number of recent cases, as the courts have continued to be busy in implementing such orders.

Perhaps the most enlightening admission of the judiciary's eclectic approach to the issue of disqualification comes from Dillon LJ in *Re Sevenoaks Stationers (Retail) Ltd.*⁷¹ where on commenting on unfitness he states:

⁶³ Supra 29-36.

⁶⁴ See ante.

⁶⁵ Janet Dine, 1991, 12 Company Lawyer 6.

⁶⁶ [1988] BCLC 341.

⁶⁷ [1987] BCLC 607.

⁶⁸ [1987] BCLC 596.

⁶⁹ Supra 50.

⁷⁰ Supra 24.

⁷¹ [1991] BCLC 325.

*"Unfitness. is a question of fact, what used to be described in the Chancery Division as a 'jury question'."*⁷²

In *Re Chadwick Warren Control Systems Ltd.*⁷³, failure by a director to disclose an interest in a company's transactions, led to a six year and a two year disqualification order. The indebtedness of the company upon insolvent liquidation was £3 million. The Secretary of State sought an order for disqualification on the basis that the directors had bought a new company without disclosing that they had a financial interest in the company being acquired.

Chadwick J. distinguished between the director who did not disclose because he wished to deliberately deceive the members, in which case a six year disqualification order was appropriate, and the director who did not wish to deceive. There a two year order was sufficient⁷⁴. This shows that while moral culpability is important in terms of 'sentencing', the order itself will be granted without having to show rashness or imprudence⁷⁵.

In *Re Gsar Realisations Ltd.*⁷⁶, continued trading by an insolvent company involving a failure by the director to co-operate with an office-holder and produce a statement of affairs - three years disqualification order. Three years was also given in *Re New Generation Engineers Ltd*⁷⁷, where accounts were not properly kept, making it impossible for the directors to keep abreast of the company's financial position, and thus not paying those creditors who did not press for payment, the Crown being the most deprived creditor. The facts are similar to *Re Bath Glass*, but in this case there was no alternative commercial activity in which the directors were participating which would have been undermined by a disqualification order.

⁷² *ibid*, p 330.

⁷³ [1993] BCLC 80.

⁷⁴ Louis Doyle: *Solicitors Journal*, 18th February 1994.

⁷⁵ *Supra* 46.

⁷⁶ [1993] BCLC 409.

⁷⁷ [1993] BCLC 435.

In *Re Swift Ltd. (sub nom SoS for Trade and Industry v Ettinger)*⁷⁸, directorial activity in sixteen other companies did not prevent the court on appeal increasing the disqualification order from three to five years, on the basis of failing to keep the appropriate accounts.

The cases illustrate that to find an objective standard which produces a uniform decision in determining the culpability for disqualification and the length of any order is beset with the same problems of discerning the attitude of the commercial world which is found in the legislation relating to wrongful and fraudulent trading. To make decisions too tight, would render the insolvency legislation too draconian, and too difficult to evidence. To make it too liberal would undermine its position as an effective policing measure.

The disqualification provision for wrongful trading is found in section 10 CDDA, and is less severe than the unfitness provision at section 6, as it does not compel the court to disqualify and there is no minimum disqualification provision. In *Re Bath Glass*,⁷⁹ it was argued that the definition of unfitness should be no lesser a test than that for wrongful trading. But the court said that the wrongful trading provision created a specific offence⁸⁰.

Nevertheless, wrongful trading can be used to furnish evidence of unfitness and thus the two sections are not completely separate. With the decision in *Re Bath Glass*, it seems clear that when the wrongful trading provision is too inflexible to use, because the facts of the case would render a disqualification order inevitable, section 6, an ostensibly tougher measure, is employed because its wide discretionary element gives the court the power not to disqualify. The wrongful trading provision becomes increasingly obsolete.

In *Re Continental Assurance Company of London* ⁸¹, Mr. Justice Chadwick stated that:

⁷⁸ [1993] BCC 312 CA.

⁷⁹ (1988) 4 BCC 130.

⁸⁰ Geraint G Howells : Directors Disqualification and Unfitness, 1988,132 Solicitors Journal 1470.

⁸¹ The Times, Monday 8th July 1996.

"gross incompetence which did not amount to dishonesty in a director of a company could be regarded as unfitness for the purposes of making an order under section 6 of the Company Directors Disqualification Act 1986."

It was concluded in that case that the director who was a corporate financier, should be able to read and understand the accounts of the company in which he was a director⁸².

The case involved a Mr. Michael Gordon Burt who was a director of Continental Assurance Company of London plc from June 1988 to November 1991. The sole allegation related to unsecured interest free loans made by Continental Assurance to Yorkdale Holdings Ltd. to enable Yorkdale to service bank loans made specifically for buying shares in Continental Assurance.

The Secretary of State's case was based on the fact that these loans contravened section 151 Companies Act 1985 as financial assistance. It was also contended by the Secretary of State that there was no ground for believing that the loans would be repaid or that there was a commercial advantage to Continental Assurance in making the loans.

The defence for Mr. Burt was that he did not know what was going on, and that had he known he would have prevented the transactions from occurring. Mr. Justice Chadwick was prepared to believe this defence even though he was of the opinion that what had been going on was plain for everyone to see⁸³.

However, Mr. Justice Chadwick's opinion was that the director did not know because he did not choose to read the relevant accounts. Had he done so, there would have ample evidence to conclude what had been happening. In not looking at the accounts, Mr. Justice Chadwick concluded that Mr. Burt had failed in his responsibilities as a director. Thus it was not his knowledge, but his failure to give himself the knowledge, which rendered the director incompetent.

⁸² *ibid.*

⁸³ *ibid.*

Mr. Justice Chadwick went on to conclude that this sort of incompetence fell short of what people expected when dealing with directors, particularly as in this case, Mr. Burt was in fact the finance director. The incompetence was gross, by 'allowing' the loans to take place.

The defence forwarded the argument that the director was only in charge of allowing the loan to take place and he had not directly been involved in its initiation. However, Mr. Justice Chadwick was adamant that the law should not be strictly interpreted, so that the more general question of incompetence could not be circumvented on the basis of a technicality. As a result, Mr. Burt was disqualified for three years.

Inconsistency has come from the nature of disqualification itself being interpreted in more than one legal context, and the legacy of the 19th century has remained inspite of the commercial expectations of creating a new morality after the inception of the 1986 legislation. The courts clearly see the gravity of disqualification as a concept in need of refinement at the point at which the case is viewed on its facts, and not something which can be the product of commercial prescription. This fact however has clearly produced a cautious attitude within the Insolvency Service and other agencies which was not the intention of the 1986 legislation on director's civil responsibilities and liabilities.⁸⁴

⁸⁴ See post.

The Effectiveness of the Insolvency Service

The net result of the judiciary's incapacity to set standards of certainty in the process of disqualification is that the Insolvency Service will only bring action against directors where it is almost certain of achieving a positive result.

In the Auditor General's Report on The Insolvency Service Executive Agency⁸⁵, figures showed that while the number of cases for disqualification brought was comparatively small in relation to the number of insolvencies, on average the ratio was 1:36, the actual success rate for the cases brought was in fact very high, 93% of cases having a positive result for the DTI.

The demands of economic expediency have mitigated the more stringent elements of the CDDA, notably illustrated in *Re Bath Glass*, but this has not been the only or indeed the most demonstrable factor in inhibiting the execution of disqualification orders. The financial strains upon the Disqualification Unit of the Insolvency Service have clearly had a marked effect on its effectiveness.

In the year 1992-1993, for instance, Official Receivers successfully submitted reports to the unit within fifteen months of the beginning of the investigation, on 35% of occasions. This compares with 49% for the previous year. The escalation in the case load was not responded to with an increase in resources, which would enable the service to function more proficiently.

The impact that this has on the effectiveness of the legislation is that time limits for disqualification orders are being exceeded with the result that application for disqualification orders are dismissed. For instance, the time limit for section 6 CDDA, is two years. Under the current financial conditions, forecasts suggest that up to 50% of applications for disqualification will not be brought because of the service's inefficiency.

⁸⁵ Report by the National Audit Office, 20th October 1993, HMSO.

The court's initial jurisdiction for allowing an application to be brought out of time is found in section 7(1) of the CDDA, which provides that:

"If it appears to the Secretary of State that it is expedient in the public interest that a disqualification order under section 6 should be made against any person, an application for the making of such an order against that person may be made:

- (a) by the Secretary of State*
- (b) if the Secretary of State so directs in the case of a person who is or has been a director of a company which is being wound-up by the court in England and Wales by the Official Receiver."*

The court does have a discretion to allow an order to be brought under section 6, out of the time limit of two years (section 7(2)). In *Re Probe Data Systems Ltd. (no.3), Secretary of State for Trade and Industry v Desai* ⁸⁶ Scott LJ said that the court should take into account the following matters when determining whether an application for an order should be made out of time: (1) the length of the delay, (2) the reasons for the delay, (3) the strength of the case against the director and (4) the degree of prejudice caused to the director by the delay. In that case, it was argued that there had been undue delay in commencing proceedings within the two year period, and that this was a factor which should be taken into account. The court held that while such delay could be relevant, it was not material on the facts of the particular case. In *Re Tasbian Ltd.(No.3)* ⁸⁷ Balcombe LJ said :

*"There can be no point in extending the time if the application is going to fail. If, however, the court is satisfied that the evidence shows a fairly arguable case on the applicant's part, then on this ground alone, that is leaving aside the reasons for the delay and any questions of prejudice to the other party, the court will not refuse leave."*⁸⁸

In *Re Crestjoy Products Ltd.* ⁸⁹, leave for an order to be brought out of time was refused on the grounds that understaffing and pressure of work on the Insolvency Service itself was not enough to justify a delay in the proceedings, and that the court would look more favourably on an application which was brought within the two year period than after it.

⁸⁶ [1992] BCC 110, p 118.

⁸⁷ [1992] BCC 358, p 362.

⁸⁸ Disqualification and Personal Liability of Directors, Fourth Edition : L.S Sealy. 1993.

The procedure to extend the time limit is made *ex parte* which is designed to filter out the unmeritorious claims which would be thrown out at an early stage. Millet J. preferred this type of application as it would enable the courts to get an overview of the case as the initial application would contain a detailed affidavit including the reasons why the extension of time is meritorious. If there was, the Respondent would be allowed to challenge the application, again providing the judge with evidence to support the claim. An integral understanding of both cases could then be realised before any decision was made⁹⁰.

Another restriction relates to the amendment of mistakes in the application.⁹¹ Here the judge ruled that the test was twofold. First, the mistake had to be genuine, and secondly, it had to be capable of amendment, such as one of the names of the parties. If the mistake is so fundamental that it constitutes a mistake at law, then the application will be thrown out. For instance, making the identity of the plaintiff ambiguous, in the hope that an amendment at a future date would extend the time limit for the eventual application. The result is that the application for the change in the originating summons was successfully thrown out.

However, the courts will not always give in to a technicality which the defence relies on to get an application thrown out. In the case of *Re Seagull Manufacturing Company Ltd.*⁹², Blackburne J. allowed an order for disqualification even though the Official Receiver had structured the summons too narrowly by including references to S.1(1) of the CDDA 1986. The judge ruled that such narrowness was irrelevant in the case, as the order sought under S.6 could be granted without reference to S.1 of the Act.

With such restrictions, both in substantive law and in procedure on the reasons for bringing an application out of time, the DTI has frequently failed to make a successful disqualification order. More recently, the DTI had its application for a disqualification order thrown out

⁸⁹ [1990] BCC 555.

⁹⁰ Abbas Mithani and Sally Wheeler : "Disqualification Orders Out of Time", 1989, 86 Law Society Gazette, 32, 28.

⁹¹ See inter alia Millet J in *Evans Ltd. v Charrington and Co. Ltd* [1983] 1 QB 810.

⁹² [1996] 1 BCLC 51.

against Mr. Asil Nadir.⁹³ In the case, which was unreported, Lindsay J. stated that there was "no good reason" for an extension to the time limit and that there had already been "unreasonable" delays in the case to date.

Most of the evidence in that case was based on reports submitted by accountants Touche Ross, and the court felt that while one report was highly critical of Mr. Nadir, there was insufficient evidence in the reports generally to justify a disqualification order against Mr. Nadir. In view of the large sums involved in the case with Mr. Nadir facing charges of £34 million for theft and false accounting, the case was highly embarrassing for the DTI.

The importance of keeping within the time limit is twofold. First it encourages the liquidator to be efficient in his preliminary investigations concerning the director of the company, and second to allow the director to restructure his business career without the fear of the disqualification order from being resurrected⁹⁴. The strictness of the provision was illustrated when, in *Re Tasbian* ⁹⁵ Peter Gibson J., stated :

"the power of the court to extend time would no doubt be used in a case where information was available after the two years were up."

This has been rejected by Millet J amongst others who restricts the extension to circumstances where the director furnished misleading information to the office holder which resulted in relevant information being received out of time.⁹⁶

The combination of judicial inconsistency and financial constraint has led the Insolvency Service to be cautious in bringing an application for disqualification. The Service's

⁹³ Report by Andrew Jack, Financial Times, 26th November 1993.

⁹⁴ Supra 89.

⁹⁵ (1989) 5 BCC 729.

⁹⁶ Supra 89

performance for the year 1992-1993, by its own admission, fell short of the targets in previous years.⁹⁷

In particular, resources dedicated to specialist investigations had to be moved to initial case work to handle the unprecedented number of insolvencies and assure standards in that area. That, combined with the increasing focus on larger, more complex corporate failures resulted inevitably in the reduction of numbers in the prosecution and disqualification reports submitted by Official Receivers (916 compared with 1,391 in 1991-92), as well as in the timeliness of submission of those reports. Interestingly, while the number of directions for disqualification orders fell by 19.4%, the actual number of orders obtained increased by 36.8% in the face of more and lengthier defences to proceedings⁹⁸.

This last statistic belies the fact that during the period 1992-1993, the actual submission of reports for disqualification orders fell to only 80% of its previous year level.

The combination of these figures, in particular the seeming discrepancy between the number of directions issued and orders achieved, displays a narrowing in the Insolvency Service's decision to initiate proceedings.

A contrast can be made with bringing proceedings for disqualification under section 5 of the CDDA. Here, a disqualification order will be made for those directors who fail to return company accounts on time. The evidential burden for this is quite straight forward, as the absence of a return of the accounts ten months after the accounting reference date for the company will mean that some action will be brought, be it a fine, or in more serious cases, disqualification.

⁹⁷ Supra 85 p 3 para 9. While acknowledging disqualification of 1700 directors the Agency points out that with the constraints of time, and identifying the basis for claims the service was not fully protecting the commercial world and the public at large against directors who abuse limited liability status.

⁹⁸ Supra 16, Appendix 4.

Magistrates seem to be increasingly keen to disqualify directors for the breach of this duty⁹⁹. Like so many other provisions of the Act, the underlying philosophy of whether the reason for disqualification is to penalise the directors or to protect the public, is uncertain. Nevertheless with the computerisation of the system the net results relating to fines and disqualification's have proven most successful. In 1992, 16 directors were disqualified for breaching S 5.¹⁰⁰

The examination of the relationship between the courts and the service has illustrated an inconsistency which prompts a more circumspect regard from the Insolvency Service as to the result of a case before it decides to embark upon a lengthy course of legal action.

The service has also faced criticism in the light of its report on Insolvency Practitioners (IPs). The report showed that out of 147 random visits carried out by its monitoring unit, 18 practitioners were identified as having "significant compliance problems". These are currently being investigated by the Law Society, which is the professional body responsible for licensing IPs.

The report went on to show that during 1992-93, detailed special investigations were begun on nine practitioners while two practitioners and two managers received custodial sentences resulting from earlier investigations. Problems highlighted by James Lingard a partner at Norton Rose included the "sloppy or dishonest administration ...or inadequate supervision rather than the fault of the legal advice the IPs are getting."

The net result is that the service cannot continue to fulfil those tasks to a sufficient degree without something having to be compromised. The wrongful trading provision as well as the disqualification provision under section 6 of the CDDA, have proven expensive luxuries which the service has chosen to ignore in favour of securing the effective winding-up of companies and distribution of those assets already in the company. The risk of losing assets in the hope of

⁹⁹ Elizabeth Hope: Maintaining an up to date Record, *The Legal Executive Journal*, December 1993.

¹⁰⁰ *ibid.*

obtaining more from the personal liability of directors is a real one as vast amounts of company capital can be swallowed up in fruitless litigation.¹⁰¹

The initiation of section 214 Insolvency Act 1986, exemplifies the nature of the underlying problem faced by the courts and the Insolvency Service. It represents a move towards greater certainty in determining standards of practice, but in doing so, compromises that degree of flexibility which the courts and the Insolvency Service have considered as important in maintaining the desire to keep directors in business despite having made errors.

The Cork Report itself commented that:

"A balance has to be struck. No one wishes to discourage the inception and growth of business, although both are unavoidably attended by risks to creditors."

To mitigate this growth in the pursuit of greater and stricter policing measures, proves too draconian and inflexible¹⁰².

One further point indicated by the Auditor General's Report is the lack of respect company directors have for the insolvency legislation¹⁰³. Fifty eight per cent of directors are currently unaware of the provisions of the CDDA, and of those who are 53% consider the legislation unsuccessful in deterring unfit conduct. Forty three per cent also thought that proceedings were not brought against a sufficient number of directors. Seventy five per cent of IPs who also responded to the survey, consider that the Act is not proving successful in putting directors out of action, while 73% consider that it does not protect the public interest. Sixty one per cent thinks that it does not deter unfit conduct.

¹⁰¹ The cost of winding-up an insolvent estate was recently viewed in the Maxwell case where the 1.5 million pounds was reduced to 68 000 after the expenses of the winding-up. This has prompted calls for a watchdog to be introduced. See The Times, July 1997.

¹⁰² "S214 Insolvency Act 1986 and the Private Company: Why it may fall short of the mark" Christina Williams, 1990, 11 Company Lawyer 222.

¹⁰³ Supra 82, part 4, figure 7.

These figures show a demonstrable disaffection amongst the commercial community with the current state of the legislative aspects of commercial governance aimed at insolvency. This fact may increase in the light of some more figures released by the DTI. In a press note released in January 1994, figures emerged which illustrated some of the sources of complaints which acted as a basis for an application for director disqualifications¹⁰⁴. The figures show that there is an expectation gap between the public and the DTI, in deciding what conduct is to be deemed sufficiently wrong to bring a disqualification order.

	Approved for Investigation	Refused	Total Considered
Members of the Public	33 (31)	138 (130)	171 (161)
Other divisions of the DTI	28 (15)	25 (37)	53 (52)
Other Regulations	12 (6)	12 (4)	24 (10)
DPP/Police	5 (-)	2 (12)	7 (12)
Totals	78 (52)	177 (183)	255 (235)

Note: The figures in parenthesis represent figures for the previous quarter.

The ramifications for the Insolvency Service is that there will be an increase in the number of members of the public who will feel aggrieved with the actions of a director, but will be frustrated because their actions will on a vast majority of occasions be refused investigation by the DTI.

There are several different problems to be faced with achieving higher levels of corporate governance through the vehicle of the Insolvency Act 1986. Firstly, there is the problem of defining the perimeter of commercial activity which will prevent a claim for wrongful trading and/or any subsequent disqualification order. In this respect, the propinquity between realising the problem and taking action seems to be an all important criterion, yet no definite time element is produced. This contrasts with, for example the German system. There, the director is compelled to petition for what is termed composition proceedings, or Vergleichsverfahren,

¹⁰⁴ DTI press notice - DTI Investigations Rise, 6th January 1994, p 94,95.

within three weeks from discovering the insolvency. A failure to do so either intentionally or through the director's negligence will result in the director being faced with a criminal charge and the obligation to make restitution to those people with whom he traded after the date of insolvency.¹⁰⁵

Second, there are the problems of resources which beset the Insolvency Service. It will depend on the number of insolvencies generally, whether the service commits itself to action against directors for wrongful trading and disqualification. The most recent figures from the DTI show that the number of insolvencies is falling from a high of 6,699 in 1992, to 5,276 for the last quarter 1993, although that in itself was a rise of nearly 100 on the previous quarter's figure of 5,195¹⁰⁶.

The effectiveness of the service's policing abilities also depends on its capacity to monitor, those people who have been disqualified. Under S.18 of the CDDA, the Secretary of State, is obliged to maintain a register of orders made under the Act. The register is then open to inspection so that anyone can discern whether a director is in fact disqualified. Despite the computerisation of the system, which deals so effectively with directors who fail to make proper returns,¹⁰⁷ the same sort of efficiency does as yet not seem to be a part of monitoring disqualified directors, as the initiative for discovering who is disqualified is left in large to those who are in business with the disqualified director.

Third, there is the increase in the number of institutional shareholders. During the 1980s, the percentage of public company equity held by institutional shareholders, had risen from 34% in 1969 to 66% in 1985¹⁰⁸. This has awakened a new interest from the public in company management which will continue to be an area of concern for those directors who up until now have maintained an utopian state of autonomy in the management of company affairs. While

¹⁰⁵ Louis G Doyle: (1992) 13 *Company Lawyer* 96.

¹⁰⁶ *British Company Law and Practice*, 96-222.

¹⁰⁷ Brenda Hannigan - *Disqualifying Company Directors*, (1987), LMCLQ 188.

¹⁰⁸ A. Cosh et al "Institutional Investment, Mergers and the Market for Corporate Control", (1989), 7 *International Fed Industrial Econ* 73, p 77.

the DTI figures indicate that this may be no more than an increase in failed attempts to disqualify company directors, it still compels those directors to be more deferential in communicating with its shareholders, and broadening their responsibilities in this area.

As the path for the director becomes increasingly paved with extra considerations responding to the public's concern for proper managerial behaviour, the ability of any one service to police all aspects of corporate governance, currently expected from the Insolvency Service, becomes increasingly difficult. As the insolvency legislation denotes a universal degree of 'penalty' as its consequence, any extra responsibilities placed upon a monitoring service may well fall outside the current ambit of court involvement. This leaves open the area of self-regulation, to fulfil those elements of corporate governance, which are at present not addressed by legislation.

Practice Direction (Companies Court : Directors, Disqualification)

At the end of 1995¹⁰⁹, the Vice-Chancellor issued a Practice Statement to streamline the procedure for disqualifying directors where there was agreement between the director, the Receiver and the Secretary of State for Trade and Industry. Until this Practice Statement, it was necessary for proceedings to be brought, which were costly and time consuming.

The Practice Statement, came as a result of the high growth in the number of disqualification proceedings that were instigated during 1995. In this respect, new amendments to the legislation through Statutory Instrument, would afford the courts greater flexibility in deciding which cases would come for trial and the question of disqualification would be dealt with as expeditiously as possible.

¹⁰⁹ The Times, 21 December 1995.

The direction extends the principles decided upon in the case of *Re Carecraft Construction Co. Ltd.*¹¹⁰. Here Mr. Justice Ferris developed a summary procedure for disqualification cases in which there were no disagreements of the material facts and no dispute about the appropriate period for disqualification.

The judge also commented on the need to reserve court time for those cases which did involve a dispute and accordingly, the practice direction is to be read in conjunction with the Insolvent Companies (Disqualification of Unfit Directors) Proceedings Rules (SI 1987 No 2023) and The Chancery Guide (The Supreme Court Practice 1995 (volume 2 paragraphs 874-899).

Clearly, the Service demands more resourcing if it is going to react to the changing fortunes of corporate life. However, that is not the only change necessary to improve the effectiveness of the service. An overhaul of the legislation is required to give clarity as to when liability will be incurred by directors and discretion to the courts so that they can view the merits of a potential disqualification case individually. This has already been exercised with the use of the partial disqualification order. The two objectives for the service is to create greater efficiency in the objectives of winding-up the corporation and to create confidence that the malpractice of directors will result in action being taken.

¹¹⁰ [1994] 1WLR 172.

CHAPTER 5

QUESTIONNAIRE

The aim of this chapter is to illustrate the amount of knowledge displayed by corporate directors of the current legal parameters which exact standards of behaviour from and impute personal liability to them. The questionnaire was composed in order to obtain this information and was directed at one hundred private and public corporations. It was answered in some detail by over 30% of those contacted. While this ostensibly low return illustrates the corporation's inability to provide time for the answers; a factor expressed in some of the letters returned, the detail of the returns provides enlightening evidence of the attitude of the corporation to the standard of directorial behaviour and the objectives of the current law and regulations which affect them.

The primary focus of the questionnaire¹ was to establish the level of director's knowledge, of the existing legislation concerning directors' duties. Of those directors who responded, 20% of them stated that they were very aware of the provisions of the Insolvency Act 1986, with a further 80% stating that they had some knowledge of the Act. Also, 33% said that they were very aware of the Companies Acts of 1985 and 1989, with 67% having some knowledge of it. Finally, 7% were very aware of the Company Directors Disqualification Act 1986, with 67% having some knowledge with 26% being unaware. To exact how up to date their knowledge of the Acts is, the directors were further asked if they were aware of the current provisions of the Acts, and the answers were 8% very aware, with 67% having some knowledge and 25% being unaware.

Their awareness of the provisions of the Insolvency Act illustrates an encouraging level of knowledge relating to the provisions of fraudulent trading and wrongful trading (with which

67% of directors were familiar and 33% unfamiliar). However, doubt as to the level of knowledge expressed by directors was raised in their attitude to the concept of “phoenix syndrome”. Many of the returns expressed dissatisfaction with the law’s ability to stop company directors from sequestrating assets from an insolvent company and starting afresh with those assets in a new corporation; freeing themselves from liability for the former corporation’s debts. The Insolvency Act currently outlaws such practices under SS. 216 and 217. This did not seem to be understood by many of the directors and their corporations. However, there is a possibility that the directors realised that the provisions were there but were making a comment on the fact that the provision is badly policed² and were circumvented by many directors in practice.

The data seems to display a gap between the ideal expectations of the directors towards their understanding of the different laws (47% thought it very important that the laws be understood, and a further 40% thinking it important), and the actual knowledge of the directors. What directors showed however, was that they had a very different view on the ability of the legislation to affect them, illustrating their belief that the legislation does not achieve the objectives for which it was implemented.

This result directly affects the purpose of wrongful trading which was to act as a deterrent to those directors who would be fearful of incurring personal liability for being too cavalier with the corporation’s, and often the creditor’s, money. These figures therefore underline those researched by the Auditor’s General Report 1993³, which also indicated that there was a lack of faith in the ability of the legislation to be effectively enforced. There did however seem to be a greater awareness of the insolvency provisions than the indirect disqualification provisions of the CDDA. However, some larger corporations were keen to point out that the provisions had less effect on them because the structures of the corporations were such that it

¹ For the full text of the questionnaire see Appendix 2, post.

² See ante Chapters 3 & 4.

³ See Chapter 4. In particular at pages 2 and 3 of the report the figures indicate that nearly 60% of directors had not heard of the 1986 Company Directors Disqualification Act, thus

was difficult to tell who was liable. Clearly the personnel in these corporations felt “cushioned” from personal liability, further undermining the legislation’s deterrent effect.

Two consequences were felt to arise from this last point. First, that directors who feared the consequences of the insolvency provisions were likely to have an assured view of their personal integrity. The insolvency provisions did not increase that integrity, but simply reaffirmed it. Second, the scope for abuse of the legislation, was greater in larger corporations, where the emphasis on policing bad mergers and ill advised policy decisions meant that a claim for wrongful trading would not be deemed an issue, even when the corporation had fulfilled the criteria for the initiation of the section⁴. This is a disturbing consequence for the legislation as those directors in the larger institutions have greater access to public funds, through direct investment through advertising or through the indirect investment of pension funds.

Ironically, this is in complete contrast to the dicta in *Re Produce Marketing Consortium* ⁵, which reaffirmed the standard of care imposed by S.214 Insolvency Act as requiring a subjective criterion based on the experience and any special skills which a director may have. In his decision, Knox J stated that the court was to have regard to the particular director and the particular company, even though this was further subject to a minimum standard⁶. The implication of this statement suggests that where corporations have a far reaching responsibility, because of the way they are financed, or because of the number of people they employ, directors should have at their disposal a better degree of care and skill than someone in a smaller corporation which has less financial resources and commitments.

undermining its ability to act as a deterrent. The report also pointed to the variation in researching evidence for proceedings as further undermining the objectives of the Act.

⁴ Only a few large firms such as Polly Peck actually go into insolvency, and so technically fulfil the prerequisite for the wrongful trading provision, under section 214 (1) Insolvency Act 1986. In most other cases, rescue packages would be available in the public interest as the affect on society in terms of losses taxes and jobs would be much more acute than in a smaller corporation.

⁵ See ante Chapters 2 & 3.

⁶ *Re Produce Marketing Consortium (No 2) 1989 BCLC 520 AT 521 para b.*

The question for wrongful trading was whether it could effectively provide the commercial world with an objective standard for directorial behaviour. Clearly, the courts have recognised the provision as providing statutory objectivity for skill and care where the common law failed to make provision⁷. For those directors which responded to the questionnaire however, the issue displays a dichotomy amongst the financial directors. In answering the question whether the law could provide an objective criteria for directors, 53% thought that the law was able, while 40% thought that it was impossible. Only 7% were undecided. For those corporations who thought that the objective standard was impossible, the breadth of the duty and the range of those expecting to benefit from that duty, were factors to be considered in concluding that the task of creating one standard, would be difficult.

It seemed apparent from those directors which had some knowledge of the legislative duties of the Companies Acts and Insolvency Act, that the best way of attaining the objectives was to increase the level of training afforded to directors both before they took office and during their employment. Of the replies received, 60% believed that some training was necessary, but this still left 40% believing that training was not essential. The majority view here clearly reiterates the objectives of *inter alia*, Pro Ned⁸, which emphasises the importance of creating effective communications between directors and those who are in a position to monitor their activities. Similarly, communication was at the vanguard of those corporations surveyed, in determining improvement in directorial skills.

Most strikingly, during the largest corporate collapse in recent years, the Queen Moat House failure of 1993/1994, its chairman John Bairstow, confessed that the corporation outgrew the size of the management and that the "loose" structure which resulted from this, prevented the

⁷ See *inter alia*, the judgement of Hoffman LJ in *Re D'Jan of London* [1994] 1 BCLC 561 (Chancery Division).

⁸ The "Promotion of Non-Executive Directors", reporting annually, on the topic of directorial training, outlined the importance of attending regular training sessions, in view of the increase in the changing role of non-executive directors. Nevertheless, the theory here can be translated to

effective communication and monitoring , essential for good management⁹. However, it may be too prescriptive to conclude that legal training alone will provide management with the necessary skills to fulfil the expectations of *inter alia*, the shareholders. Obviously, there is a perceived need from within industry that more detailed training is part of an overall package to enhance directors' performances.

The concept of limited liability is the over-riding advantage of incorporation. Nevertheless it also raises some of the most important reasons for the drive to improve the responsibilities of directors that take its advantage. It is of no surprise therefore that there is overwhelming support for the use of the corporation as a means for conducting business. In response to the questionnaire on this issue, 67% of corporations lent themselves to the notion that to trade through a corporation was desirable, while only 25% thought that it was undesirable. Eight per cent were undecided. These figures, read in conjunction with the above figures on directorial training, bring with it some interesting attitudes of finance directors. First, there seems to be a substantial number of directors who are conscious of the advantages of incorporation, but who also realise that with these rights comes corresponding duties. One of the major points of scepticism regarding the court's attitude to directors and their position in the corporation, is that the advantages of corporate status are always utilised while the responsibilities are too often avoided¹⁰.

Second, in justifying the use of the corporate form, the directors were aware of the advantages of limited liability in the corporation, and also, its structural efficiency within the commercial world. One of the major concerns from directors however, was the abuse of the

executive directors as a part of the general change to the legal position of directors. September 1992.

⁹ See "The Sunday Telegraph" 27th February 1994.

¹⁰ For a commentary on the reasons for ensuring that the corporation is used with equal amounts of responsibility, when declaring the concept of separate legal entity voidable, see *inter alia*, "Piercing the Corporate Veil and the Insolvency Act 1986" The Company Lawyer Vol 6 No3. Wilkinson, and "Lifting the Corporate Veil in the Pursuit of Justice" 1990 JBL. Gallagher and Ziegler. These articles comment on the need to curb directors from utilising the corporate form for ulterior, often personal motives. Clearly, the corporation's integrity as a legal concept has to be upheld, resulting in the corporate veil being raised.

corporate form by those larger corporations who set up subsidiaries to test the market, with the knowledge that the parent corporation remains safe upon the subsidiary's insolvent collapse. This problem, is indicative of the court's restrictive view to lifting the corporate veil to try and produce an equitable result, in forcing liability onto the parent corporation.

This fact was illustrated in the case of *Multinational Gas and Petrochemical Company v Multinational Gas and Petrochemical Services Limited*.¹¹ Here, the liquidator acting on behalf of the plaintiff subsidiary, sued the parent oil corporation to get at its wealth, which it was hoped would pay off the debts of the subsidiary. In the judgement, appeal to serve the parent corporation out of the jurisdiction was denied on the basis that there had not been any *mala fides* by the parent corporation in setting up the subsidiary and that only the inclusion of such *mala fides* would produce a lifting of the corporate veil¹². As the corporation was not a sham ab initio, then the separate identity would remain¹³.

This position contrasts with that in Germany, where under the German Companies Act 1965, a detailed and complicated provision relating to group enterprises, provides for inter-group liability. The concept is called integration (*Eingliederung*), and occurs where the parent corporation holds such a substantial share in the subsidiary that they can be treated as one economic unit¹⁴. Under S.322 of the Act, a parent corporation will be liable for the debts of a subsidiary in a joint and several manner, and the concept is a recognition of the parent company's power over the subsidiary¹⁵.

¹¹ [1983] 3 W.L.R 492 C.A.

¹² See *ibid*, Dillon L.J. p518, Lawton L.J. p501 and May L.J. at p 511.

¹³ See Wedderburn . 1984 M.L.R p92.

¹⁴ German Companies Act 1965, s.319. If the parent holds 95 per cent of the shares of a subsidiary it may acquire the remaining 5 % compulsorily. A similar provision is found in Section 429 of the Companies Act 1985, concerning a shareholder who has 90% of the company shares. See *Re Chez Nico (Restaurants)* [1992] BCLC 192. The sections illustrate the presumption in corporate law that the practical consequences of such a large holding can produce a right to confirm that holding through consolidating the share ownership. Thus the economic reality of the situation is supported.

¹⁵ H. Wurdinger, "German Company Law (Oyez LONDON, 1975) p 145.

The British position clearly requires something more than the control factor to try and raise the veil on parent corporations to settle the debts owed by their subsidiaries. The concept of wrongful trading¹⁶ has it is hoped, been received as one of the legal devices to obtain such liability in the absence of fraud¹⁷, and to mitigate the abuses of corporate veil, which has left many unsecured creditors without legal action while parent corporations prosper. As Templeman LJ stated in *Re Southard & Co.*¹⁸:

"To the dismay of its creditors, the parent company and the subsidiary companies may prosper to the joy of the shareholders without any liability for the debts of the insolvent subsidiary."

The Cork Report¹⁹, raised the issue of inter group liability based on the German system of Konzern, but the initiation of wrongful trading, can be seen as an attempt to patch the problem of inter group liability in the absence of a formal set of principles which will state when group liability will take place.

The basis of liability for the parent corporation under S. 214 Insolvency Act occurs when the subsidiary trades while insolvent and the directors fail to wind the subsidiary up when there was "...no reasonable prospect that the company would avoid insolvent liquidation". The concept of director is defined in S.251 as "any person occupying the position of director by whatever name called". Under Schedule 1 of the Interpretation Act 1978, "person" includes company, so that if the subsidiary acts in accordance with the management of the parent corporation it can be said that the parent can be a director which can be made liable for the wrongful trading of the subsidiary²⁰.

The success of the provision depends on how ready liquidators will be able to invoke the concept, to try and obtain liability from parents in a group. With the ambiguities already

¹⁶ See ante Chapters two and three.

¹⁷ See inter alia, *Jones v Lipman* [1962] 1 WLR 832 and *Re a Company* [1985] BCLC 333, where the concept of fraud was central to the decision to lift the veil in the circumstances.

¹⁸ [1979] 1 WLR 1198

¹⁹ See ante Chapters Two and Three

surrounding the successful application of the section, it may be that the liquidator will be disinclined to try and unveil the parent, and to compromise the seemingly unassailable concept of separate legal personality. The time and expense of the claim for wrongful trading may also prove a disincentive for application²¹.

In the meantime, while the enforcement of the provision is subject to financial and procedural difficulties, the strict position of the English law remains intact as was illustrated in the case of *Adams v Cape Industries*²². Here, a parent company, Cape Industries, could not be made liable for liabilities imposed on its subsidiary by the American courts. Here, there were several hundred plaintiffs who were claiming compensation for asbestos damage caused by the subsidiary of Cape, NAAC. In his judgement, Slade J, rejected that the companies were a single economic unit, and rejected the idea that a such a principle could generally be enforced in a group of companies. Instead, he re-enforced the view of Roskill LJ, in *The Albazero*²³ that:

“each company in a group of companies (a relatively modern concept) is a separate legal entity possessed of separate legal rights and liabilities”.

While his Lordship had sympathy for the plaintiffs in the case and was aware of the fact that the lay-man would presume that the two companies were the same, there were in his opinion, too many injustices that could arise from making the group a legal single entity. They looked to legal technicalities for justifying the decisions of, *inter alia*, DHN Foods.

The expectation gap between the public's perception of corporate responsibility and the legal justifications for limiting that responsibility was illustrated in the Auditor's General Report (October 1993)²⁴. Here, of the 171 complaints initiated by the public against directors, only 33 were investigated. The expectation gap represents a problem in that it shows that in their

²⁰ Andrew Wilkinson. "Piercing the corporate veil and the Insolvency Act 1986." 1987 *The Company Lawyer* Vol 8 No 3 p124.

²¹ Ante Chapter 4.

²² [1991] All ER 929

²³ [1977] AC 744 at 807

quest for justice, the general public will perceive the particular circumstances in which a corporate wrong has taken place as justifying a particular course of action; disqualification for example. However, the judiciary's approach to the corporation's management, ostensibly one of non-intervention, has to balance the needs of the general public, and the corporation's benefit to it, with the needs of the smaller group of individuals who at the time of the corporate wrong will feel aggrieved.

From the inception of its use, the corporate form will be treated by some of its directors as an engine for manipulation and even fraud. Where the courts have lifted the veil, the directors have been liable for such abuse²⁵, but with the inadequate policing measures which are a consequence of the lack of funding and ambiguous and difficult legislation, the Insolvency Service is failing to act as the effective watchdog which the inherent powers of the Insolvency Act 1986 were designed to impose²⁶. In particular, corporations which responded to the questionnaire, were concerned for the use of the corporate status to offset their liabilities, by going into insolvent liquidation, and then setting up a new corporation, using the assets of the previous insolvent corporation; the concept known as "phoenix syndrome."

This concept was made illegal under SS. 216 and 217 Insolvency Act 1986, which banned the use of the corporate name of the company which had gone into insolvent liquidation, for a period of up to five year after the insolvency²⁷. The result of trading in contravention of this

²⁴ ante 19

²⁵ See inter alia, *Gilford Motors Co Ltd v Horne* (1933) Ch 935 (Court of Appeal), and *Jones v Lipman* [1962] 1 ALL ER 442

²⁶ "Efficient Disqualification : Auditor's General Report on the Insolvency Service Executive Agency: Company Director's Disqualification." Tim Pryce-Brown. (1994) International Banking and Financial Law Journal.

²⁷ Section 216 (3) Insolvency Act 1986. This states: 'Except with leave of the court or in such circumstances as may be prescribed, a person to whom this section shall applies shall not any time in the period of 5 years beginning with the day on which the liquidating company went into liquidation -

(a) be a director of a company that is known by a prohibited name, or
(b) in any way, whether directly or indirectly, be concerned to take part in the promotion, formation or management of any such company, or
(c) in any way, whether directly or indirectly, be concerned or take part in the carrying on of a business carried on (otherwise than by a company) under a prohibited name.

section is a fine, imprisonment or both²⁸. This illustrates two factors about the section. Firstly, the quasi criminal nature of the activities displays the problem of defining this sort of directorial behaviour and then applying an appropriate set of legal principles to it²⁹. In particular, the time limits in which an action can be brought and the problems of trying to define an appropriate objective for the legislation, has meant that cases are often not brought against directors for fear of wasting public money when not being able to secure a conviction³⁰. The commercial community seems to be in tune with the perception of being able “to get away” with “phoenix syndrome”, and clearly commercial expediency will demand it, where the subsequent corporation proves to be a success.

This produces a fundamental second problem of corporate monitoring, based in the construction of appropriate degrees of monitoring and repercussions, for different corporations. Clearly, within the legal framework in which we currently find the corporation, the application of the appropriate areas of the Insolvency Act are proving inadequate, too prescriptive and poorly funded³¹.

Prescribing one formula for the future of governance will be perhaps the most difficult and controversial issue in the future of corporate control.³² The use of the Cadbury Code with its emphasis on the initiation of different committees and sub-committees,³³ has indicated the strength of the reaction to a prescriptive formula for governance³⁴. The responses to the questionnaire indicated a similar pattern. Of those directors questioned, 53% were familiar with the Cadbury Code, while 7% were neutral, and 40% were not familiar.

²⁸ Section 216 (4) Insolvency Act 1986. States: If a person acts in contravention of this section, he is liable to imprisonment or a fine or both.

²⁹ ante 26.

³⁰ *ibid*

³¹ *ibid*

³² See inter alia, Tricia Gardom, Group Marketing Director, F I Group plc. Fabian Society Conference, St Ermin's Hotel London, September 20th 1995. She argues that the future of governance was to recognise the subjective needs of different corporations and to recognise that the nature of the concept of stakeholder will be different for each corporation.

³³ Post Chapter Seven.

³⁴ In particular, criticism has come from Sir Owen Green, and others who see the imposition of such committees, as a costly and time consuming restructuring programme.

The thrust of the Code, was aimed at listed corporations and large public and private corporations, although it was hoped that the objectives would filter through to the medium and small corporations³⁵. It seems however, that the Code has only been incorporated by those who are large enough to undertake the cost of the Code's recommendations, and even within that group, the recommendations are incorporated on a piece-meal basis and not embraced in full³⁶. The split in the familiarity with the Code thus reflects the growing diversity in the attitude of corporations to the non-legal governance devices which are currently advocated in the corporate community and which can be seen as further evidence of a non-intervention policy of the Government³⁷.

However, while only half of those companies questioned were familiar with the Code, an overwhelming 73% of responses, approved legislation as an appropriate device to enhance standards of corporate behaviour, and only 20% approved of the voluntary code. The reasons for this are several, but in particular, the Code does not give the sort of clarity which can be afforded by legislation. Legislation has the ability of first defining the group of corporations which will be effected by the Code and perhaps more importantly, the penalty for non-compliance. The Cadbury Code is vague on both concepts, but in particular, the reaction to non-compliance is to be treated with scepticism.

In the Code, non-compliance has to be indicated to other corporations, by the insertion of a clause in the corporate returns indicating that compliance with the Code is not complete, and to give the reasons why³⁸. However, such a "penalty" can hardly detract from a prestigious commercial performer which decides not to implement some of the Cadbury provisions, because, it may actually have better in house provisions. A trading partner will not be deterred from dealing with the non-complying corporation if there is a profit to be exacted

³⁵ ante 33.

³⁶ *ibid*

³⁷ *ibid*

³⁸ *ibid*

from the relationship. In this respect, the Code's credibility is undermined but also, it fails to compel corporations to address the issue of governance in general.

Yet, the concept of governance is something with which the overwhelming number of corporations are familiar. In response to the questionnaire, 67% said they were familiar with the term, 20% said they were undecided as to what the term meant and only 13% said that they were undecided. This reply gives the most significant illustration that the concept of governance is one of the most important issues to dominate corporate life in the nineties. This consciousness however, raises issues at the very core of governance which creates some confusion amongst those who are affected by the corporation.

First, what do directors mean by the term corporate governance. The answer to this question lies in the expectation of the officers, and of society to the concept of the corporation itself. There has clearly been an enormous increase in the number of corporations listed in the UK. The figure has changed from 14,000 in 1891, to over 1 million today³⁹. The corporations range from 25% having more than 5,000 employees and a turnover of £250 million, while at the other end of the scale over 25% have less than 50 employees, and one in five have a turnover of less than £1 million.⁴⁰ With such a broad cross section of corporate entities, it is not surprising that the definition of governance to one director will be quite different from that of another.

Yet there are some important definitions that have been furnished to try and at least carve an outline for the concept. At the broadest definition, the concept is "... the issue of the relationship between the stakeholder in a company and those who manage its affairs (the board of directors)⁴¹. Here, the duties of the directors are broadened beyond the traditional

³⁹ Figures taken from a paper given by Professor Stephen L Bristow. "Corporate Governance-A cross-Sectional View. 1995 Conference of the ICSA Alberta Branch.

⁴⁰ *ibid*

⁴¹ Professor D D Prentice "Some Aspects of the Corporate Governance Debate" from "Contemporary Issues in Corporate Governance, 1993 (25)".

duty to the corporation and the shareholder, and are placed in a more circumspect category having regard for, inter alia, employees, creditors, the environment and society in general.

In a narrower sense, the concept has been viewed as expressing the relationship between the directors and the non-executive directors, whose job it is to ensure that the directors are accountable for their actions. In this respect, the non-executives are acting on behalf of the shareholder. Thus the answer to the question of who monitors management (thus creating governance) "...: independent outside directors elected by shareholders"⁴².

For the Cadbury Committee, the definition lent towards the narrower definition, describing corporate governance as:

*"the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place."*⁴³

This perception of governance coming from inside the corporation, is one which visualises governance with management. The two are so close that they must invariably interchange. The influence of the unitary board in the British and American systems of management has encouraged this introspective evaluation of governance. The citadel has been challenged, from various areas⁴⁴, who confront this "good housekeeping" approach to governance, and who reject the argument that a change in governance requires not a managerial change but a philosophical change, encouraging greater input from other strands in the corporate nexus⁴⁵.

The question of governance is affected by the expectations of those who have an interest in the corporation, and the perspective that comes with a particular input. The shareholder may

⁴² ante at 39, p4. The quote is taken from Frederick G Hilmer "The Governance Research Agenda: A Practitioner's Perspective" Corporate Governance Vol 1 No1, January 1993.

⁴³ See post Chapter Seven.

⁴⁴ "Corporate Governance: An Action Plan For Profitability and Success" Thomas Sheridan and Nigel Kendall.1992.

have a blinkered perception of governance as one which exacts more profit, while the employee will emphasise the need for greater management input from an elected stakeholder body. The creditor may emphasise the need to protect his security. All part of the corporation as a going concern, and all with their own agenda.

Yet within this struggle for choosing an acceptable and circumspect prescription for governance, there has been some cohesion, that the purpose of a corporation is to make a profit. The emphasis for how much and when may be influenced by the particular group's agenda in the corporate nexus, but to survive as a whole the corporation must make a profit.

This again has been challenged⁴⁶ on the basis that corporations are not there to make profits at all but rather to make things, of which the profit is only one part. Professor Handy has described the corporation as an "*hexagonal ring*", with pressures coming from all those who constitute the stakeholders. Within these groups, the corporation stands as a separate legal person, and its purpose should be to fulfil itself "to grow and to develop the best that it can be, given always that every other corporation is free to do the same."⁴⁷

Yet the traditional perspective of the relationship between the different stakeholder groups, has put a barrier to allowing the stakeholders to reassess their position viz. a viz. each other. The contrast is illustrated in the attitude of the different groups in the German and Japanese nexus with that of the British position. For the foreign counter-part, the corporation is their to facilitate society and to encourage investment for the future. It becomes an intrinsic part of the society and not a forum for the polemic structure within society.

The objective for governance is thus to marry the requirement of the efficient running of the corporation with the balancing act of protecting the interests of the different groups within

⁴⁵ See for example the role of shareholders and employees in the larger German corporation which constitute Supervisory Boards. For a full discussion on these see chapter six

⁴⁶ Ante at 39 p5.

⁴⁷ *ibid*

the corporation. In considering that balance however, the traditions and cultures imposed by a particular society will be most important⁴⁸.

Perhaps the most revealing discovery from the directors who responded to the questionnaire, was that the commercial world believes that the current available choices for incorporation are sufficient. Of those directors who replied, 80% thought that there was a sufficient variety of corporate forms from which to choose, while only 20% thought that more choice could be made available.

Satisfaction with the traditional corporate forms that are on offer, illustrates an attitude amongst corporate managers, that the company merely facilitates the objectives of best performance and profit. In the survey, these were the first and second most important objectives respectively. With these objectives firmly set above the others, the issue of extending more information to shareholders, and improvement in managerial structures are placed in lower priority.

Perhaps the contentment is a product of the fact that the law has been modified for different types of corporations, according to their size, and that tailoring a particular corporation to its individual needs in practice, is something which can be achieved⁴⁹. However, the ad hoc approach to corporate evolution illustrated in the reforms to the Companies Act 1985⁵⁰, are an indication that company law recognises the importance of sensitivity to the tailoring of

⁴⁸ "Shareholder Protection-A Cultural Quagmire" Tim Pryce-Brown. *The Company Lawyer*. 1995 Vol 16 No.4

⁴⁹ In particular, smaller corporations can benefit from the use of the elective resolution, which gets rid of some of the more cumbersome requirements for a general meeting. Small corporations can also submit abbreviated accounts, under Section 246(1A) Companies Act 1985 (inserted by SI 1992 No.2452, reg.4), providing the director can show that the corporation could take advantage of the provision. The small corporation can also dispense with the need for an annual audit (s249(A). Companies Act 1985. On the other hand, larger listed corporations will find themselves subject to the City Code on Takeovers and Mergers, The Cadbury Report and The Greenbury Report on Directors Pay, all influential as to best practice, but without legal authority.

⁵⁰ *ibid*

commercial requirements and that the corporation in law is still too unrefined to achieve this⁵¹.

However, the response of directors to the need for more restrictions when the corporation increased in size, indicated an inconsistency. Here, most financial directors believed that the directors should be subject to greater controls when the corporation increased in size. Directors seemed to fail to recognise that the problem of translating greater controls that can be focused on a particular group of companies, lay in the fact that while there is a bifurcation of limited corporations in practice, the nature of the controls envisaged necessitates further refinement in the legal construction of corporations. Only then can law be applied effectively to the appropriate corporation.

As part of the improvement in monitoring, directors were asked if the following were important:

- a) Director's duties
- b) Communication with shareholders
- c) Communication with creditors
- d) Financial intake, i.e. credit

Corporations seemed to emphasise different priorities here, influenced by the size and nature of the corporation. Director's duties were however something which most corporations felt could be improved and clarified, with some corporations emphasising the public interest

⁵¹ The DTI have already initiated a proposal for a new type of small corporation, in its document : "Company Law Review: The Law Applicable to Private Companies, A Consultative Document. November 1994." Here, a proposal of a hy-brid between the partnership and the small corporation was advocated to engender a commerca animal which is both commercially efficient and provides some limitation as to liability.

element in this area. This represents the current debate in managerial circles concerning the establishment of a best practice for boards and their managers⁵².

However the problem with the managers response to the debate on good board practice, was that it focused on making the board more efficient, and did not deal with the more fundamental questions concerning who should benefit from the improvement in the director's performance. Another issue not dealt with was how corporations should develop in their responsibilities to those who constitute the contractual nexus of the corporation in the future.

The debate is set to continue, but the DTI has produced a discussion document on the improvement of shareholder activity in the AGM⁵³. In doing so it recognises that the future of good corporate governance requires a more circumspect relationship between the director and others in the corporate nexus, which will have the consequence of encouraging discussion and debate within the corporate structure.

For the corporations that responded to the question of whether greater regulations should be placed on the corporation as it increased in size, the emphasis was on improvement of the directors duties, and those who answered affirmatively to this were also keen on greater communications with shareholders.

However, the issue of communication with shareholders was considered less important by many of the corporations than with other groups in the corporate nexus, in particular creditors and secured creditors in particular.

⁵² Inter alia, "Standard of Good Practice for UK Boards of Directors." Focus Group 13: 24 June 1994. Also, "Good Practice for Boards of Directors" Henley Management College, on behalf of the DTI. April 1996.

⁵³ "Shareholder Communications at the Annual General Meeting" A Consultative Document. Department of Trade and Industry. April 1996.

In this respect, the responses indicate the general reaction to progress on the issue of extending directors duties⁵⁴, as the differing groups jostle for supremacy. However, progress in the Commonwealth on a general duty to creditors is still in advance of the British position⁵⁵. The use of the wrongful trading provision being perceived as too limited a concept to be interpreted as a device for establishing a general duty to creditors⁵⁶.

This is an indication of a more general feeling of despondency towards the effectiveness of the Insolvency Act to act in the effective orchestration of good governance. In responding to the question of whether insolvency law was an effective mechanism by which to monitor the director's performance, 40% stated that it was an effective mechanism, while 40% thought it ineffective with 20% undecided. These figures are in fact better than those collected by the Insolvency Service, which indicated that nearly 70% of corporations thought that the present insolvency legislation was ineffective⁵⁷.

The difference can be explained by defining the remit of the question. For corporations which are facing insolvency, we can look at the legislation as a code for action at that time, a breach of which will render the directors personally liable for the company's' debts as well as being subject to a disqualification order⁵⁸. However, when Section 214 is broadened to act as the statutory definition of the director's common law standard of care and skill , it can be viewed as a "Sword of Damocles" which may fall on any occasion. While there are doubts

⁵⁴ Riley. "Director's Duties and the Interests of Creditors." *The Company Lawyer* Vol 10 No.5 1989

⁵⁵ *ibid* and ante Chapter Four.

⁵⁶ *ibid*

⁵⁷ ante 26

⁵⁸ For wrongful trading, this is a compulsory order under Section 10 Company Directors Disqualification Act (CDDA) but for actions which may render the director unfit to be a director, the evidence which may be furnished by an action for wrongful trading, will result in a dismissal under Section 6 (CDDA). The major difference in application of the two sections is that while wrongful trading has a disqualification order which only looks at the actions in the present corporation, Section 6 of the CDDA takes into account director's actions in another corporation, thus giving the director an opportunity of proving himself worthy of being a director with reference to other actions. See also *Norman v Theodore Goddard (a firm) [1991] BCLC 1028* in which Hoffman J stated that he was "willing to assume" that the test for a director's duty of care allowed the court to take into account the knowledge skill and experience which he actually had in addition to that which he ought

that this will be a cutting provision, clearly it is sending a message to some directors that the law has moved on from the days when a rudimentary subjective approach was taken to the director's duty of skill and care⁵⁹.

The continuing evolution of this process, has resulted in a fundamental overhaul of the basic philosophy behind the use of the corporation. This has necessitated the law to look at that philosophy and to exact changes which fulfil the often conflicting themes within it⁶⁰. In response to the questionnaire, corporations did not in fact look solely at profit as the most important objective of the corporation. Instead, the performance of the corporation was considered to be the most important.

The difference between the two is subtle but significant. The sole objective of profit, signifies a short term perspective of the corporation which is designed to return a dividend annually. This includes in its objective, the opportunity of using the corporation merely to fulfil a financial commitment for one or two years, and does not necessitate any deeper consideration of the corporation's future. Monitoring performance however, while providing the corporation with the profit it needs, does so with further objectives in mind. This is to preserve the medium to long term future of the corporation. In doing so, the benefits of profit are contextualised in a greater objective which has as its beneficiaries more groups within the contractual nexus of the corporation than the shareholder⁶¹. Governance has thus been defined in broader terms than the efficiency motivation for profit.

to have as a person carrying out his function. Again the submission was based on section 214 (4) IA 1986.

⁵⁹ For example, *Re City Equitable Fire Insurance Corporation Ltd.* [1925] Ch 407 and *Re Brazilian Rubber Plantations and Estates Ltd.* [1911] 1 Ch 425. These cases have recently been challenged by the wrongful trading provision which has been defined in the case of *Re D'Jan of London* [1991] (ante 5) as providing the statutory definition of director's duty of skill and care, as being a partly subjective and partly objective test see post Chapter Four.

⁶⁰ Ireland "Corporate Governance, Stakeholding, and the Company: Towards A Less Degenerate Capitalism?" 1996 Journal of Law and Society.

⁶¹ *ibid*

Questionnaire

How that objective is broadened will remain subject to the directors placing their own security against the rigours of personal liability, in front of corporate communication and administration. The lessons of Queen Moat House⁶² and the recent reports on the appropriate input from shareholders at the general meeting⁶³ illustrate that director's liability may well depend on the efficient and well developed use of both these areas of corporate activity.

Clearly, the motivation for changing the director's obligations to the corporation and its contractual members, indicates a need to incorporate the changing corporate structures and expectations of post war Britain⁶⁴. So far the ad hoc approach to raising standards of practice by the Board, has resulted in a dichotomy in the perception of corporate governance by corporate directors. The questionnaire affirms some of the misgivings with the present policing devices which the law has at its disposal to control director's behaviour, but it did show that the commercial world is prepared for change and in this change the need for improved director knowledge.

⁶² See post Chapter Seven.

⁶³ ante 53.

⁶⁴ See the debate in Chapter Four on the evolution of the directors duties in the context of the diversification of ownership and control, illustrated by inter alia, Berle and Means.

CHAPTER 6

DIRECTORS DUTIES AND GOVERNANCE

DIRECTORS DUTIES TO THE SHAREHOLDERS AND CREDITORS

The aim of this chapter is to reflect upon the legal position of the director in exercising his duties during his time in office. Within this chapter the development of that duty will be assessed as it responds to the changing economic and social relationship which exists between the director and those other groups both inside and outside the corporation who claim to constitute the structure of the corporate nexus.

The orthodox position relating to director's duties is founded in the concept of the director as trustee and that that duty of trust implies fiduciary obligations to his company as opposed to any particular group within the corporate nexus. This traditional position was illustrated in the now famous case of *Percival v Wright*¹. Here the plaintiff shareholders offered the defendant directors their shares in the company, which the directors agreed to purchase at price of £12.50. After the sale the shareholders discovered that the company was in negotiations to be taken over and that the directors knew this. The court confirmed that the directors were under no legal duty to inform the shareholders of the impending take-over, as their duty was to the company and not to the individual shareholder. Swiften Eady J. stated :

*"The contrary view would place the directors in an invidious position, as they could not buy or sell shares without disclosing negotiations, a premature disclosure of which might well be against the best interests of the company. I am of opinion that directors are not in that position."*²

¹ [1902] 2 Ch 421.

² *ibid* at p426.

The judge's quote has since been subject to some refinement, where the disclosure of information to shareholders prior to a take-over bid was deemed necessary. In the case of *Re Chez Nico (Restaurants) Ltd.*³, there was a purchase of shares in a public corporation with the intention of converting the company back into a private corporation. Here Sir Nicholas Browne-Wilkinson VC concluded that in a situation where the plaintiff was demanding the compulsory purchase of shares under S.429 Companies Act 1985, the court under S.430(c) could take into account the City Code on Take-overs and Mergers, which required the plaintiffs in the case to owe a duty to shareholders to give full disclosure of the corporation's performance before any acquisition of the shares was made⁴.

This case has several points to note in considering the ambit of directors' duties to shareholders. First it illustrates that British courts are prepared to imply a duty from the director to the shareholder in certain circumstances. This is in line with Commonwealth decisions which have implied such a duty for some time⁵. However, Sir Nicholas Browne-Wilkinson V-C made it clear to the defendant's solicitor in *Re Chez Nico*, that these cases would not be the reason for the shift in emphasis on the issue of directors' duties, but rather the extension would be based on the City Code on Take-overs and Mergers⁶. The importance of this is that it confirms the evolution of company law into the area of non legal regulation, which has become far reaching and controversial⁷.

It also highlights the debate concerning the relationship between the director and the shareholder. The case of *Re Chez Nico* indicates that in certain circumstances, a duty to shareholders is necessary, but any general duty should also be sensitive to the fact that the

³ [1992] BCLC 192

⁴ *ibid* para i.

⁵ See *inter alia*, *Coleman v Myers* [1977] NZLR 225 and *Allan v Hyatt* (1914) TLR 444 (Privy Council).

⁶ *ante* 3.

⁷ See post Chapter 7, and *inter alia*, Dine "The Governance of Governance" 1994 *The Company Lawyer* Vol. 15 No 3.

director has obligations to others in the corporate nexus and that can not be undermined by placing one group in priority⁸.

The problem which exists for the director is that the relationship with the shareholder no longer reflects that closeness which was a characteristic of the nineteenth and early twentieth century attitude towards the shareholder/director duty. This position has been illustrated in several cases on the subject of directors' duty of care and skill⁹. Today, the directors of large and medium sized corporations will have very little knowledge of the shareholders, far different from the notion that the shareholders were the ones with intimate knowledge of their director hence their decision to appoint. Any duty based on such a narrowly focused group may also limit the director's perspective on the corporation acting as a vehicle for all the nexus groups.

The challenge for the law relating to directors duties is that it has developed the legal relationship between the directors and those inside the corporate nexus on a piecemeal basis; responding to one group at a time and often in response to a particular set of circumstances which has led the court to reflect upon the *status quo* of the director's duty towards one particular group.

This is particularly true in focusing on the directors' duties to creditors which has followed a similar path towards clarity in establishing whether a similar duty is owed to that towards shareholders. The traditional position was illustrated in *Multinational Gas and Petrochemical Co. v Multinational Gas and Petrochemical Services Ltd.*¹⁰. Here a duty to creditors present or future, was emphatically rejected. The position is similar to that in the US which has also

⁸ See report by Philip Basset "Boardrooms - too biased towards the shareholders". The Times, December 30th 1996. This follows a report backed by the Stock Exchange and headed by Sir Ronnie Hempel, ICI chairman. The focus on serving the current shareholders, the report concluded, was likely to leave the director in breach of his fiduciary duty.

⁹ See post *Re City Equitable Fire Insurance Company* (1925) CA and *Re Brazillian Rubber* (1911)

¹⁰ [1983] Ch 258, [1983] 2 ALL ER 563 (Court of Appeal) per Dillon LJ and also *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 AC 187, [1990] 3 ALL ER 404 (Privy Council).

shown that beyond any contractual obligations, the director owes no duty to creditors.¹¹ The position has however been challenged in the case of *Winkworth v Edward Baron Developments Co. Ltd.*¹². Here Lord Templeman stated :

"...A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors".

However it is conservatism which is evident in the attempts to extend the duty of directors to the creditor. In the case of *Asia Bank EC v National Mutual Life Nominees Ltd.*¹³, the court was not prepared to include creditors in the list of those to whom the director owed a duty of care. Lord Lowry in his judgement affirmed that directors do not owe a duty of care to creditors even when as in this case there was a prima facie case against the directors for breach of trust. However the position would be different if the directors had assumed a special duty of care to creditors as a result of a special agreement or representation.

The court in *Asia Bank* concluded that the directors had such a duty to the creditors here because the directors had knowledge of a monthly report to which they should have responded. However, the bank was not vicariously liable for the directors because they had not acted as agents for the bank but for the plaintiff's company AICS in which they owned a 40% share. The result of this was that the bank was not held liable as a shadow director and thus should not be made to make a contribution to the £4 million claim by the plaintiff.

The cases commenting on the proposition of a duty to creditors are important for several reasons. First it confirms the position of the director not owing a general duty to the creditor but that that position may change as the company moves towards and into insolvency¹⁴. This

¹¹ See *Pittman v Pearce*, 8 Cal. Rptr. 2d 359, 366 (Cal. Ct. App. 1992).

¹² [1987] 1 ALL ER 114 at 118.

¹³ [1991] 1 AC 187, [1990] 3 All ER 404 (Privy Council)

¹⁴ This position reflects a similar change of emphasis as that displayed in the US. There, the Chancellor of the court of Delaware has ruled that " a director of a solvent company in the vicinity of insolvency should realise that they have a duty to the corporation which includes creditors and all corporate constituencies, not just shareholders" (*Credit Lyonnais Bank*

philosophy is central to the provisions of wrongful and fraudulent trading¹⁵. However, it also illustrates that the orthodox position relating to directors duties stays very much in place where the court considers the position of the bank as a shadow director thus preventing the creditor from seeking redress from a source with far greater funds.

The court has already displayed some willingness to incorporate the creditor into the group of insiders to whom the directors owe a duty. In the case of *Winkworth v Edward Baron Ltd.*¹⁶.

Lord Templeman states:

*" A company owes a duty to its creditors, present and future...the company owes a duty to keep its property inviolate and available for the repayment of its debts..."*¹⁷

The case is peculiar in its facts. Here a wife wanted to enforce her equitable interest in the matrimonial home, owned by the company of which she and her husband were directors and shareholders. The application failed firstly because it was a matter of construction for the criteria of obtaining an equitable interest in the property. A reduction of an overdraft for which the house was security was not a sufficient payment to constitute an equitable interest. Second and more importantly, it was ruled that the wife failed in her duties as a director to the company and its creditors by failing to ensure the company was properly administered, in that she had not been aware of her husband's fraud in obtaining the new finance.¹⁸

Perhaps the idiosyncratic nature of the case lead to the judge making the comments concerning the commitment to the creditor. The case has since been over ruled¹⁹but it shows

Nederland N.V. V Pathe Communications Corp., Civ Act. No. 12150, 1991 WL 277 613, at 34 n.55 (Del. Ch. Dec.30, 1991). This has been dubbed "the footnote of the year" by some academics, as it clearly raises the problem of defining what constitutes the "zone of insolvency". However, this case is seen not as establishing a direct action for contract creditors against directors, but rather to highlight the potential conflict that will arise where an agreement has taken place between the company and a major lender to give that lender voting rights.

¹⁵ See ante Chapters Two and Three.

¹⁶ [1987] 1 All ER 114, [1986] 1 WLR 1512.

¹⁷ *ibid* respectively at p 118 and 1516.

¹⁸ *Supra* 16

¹⁹ *Supra* 13

that there is at least a minority group which is prepared to broaden the ambit of directors' duties to others within what is the traditional groups constituting the corporate nexus. In doing this the UK will be consolidating the position already illustrated in the Commonwealth²⁰.

The US has also developed the principle of the 'trust fund doctrine' in which directors will be liable to the creditor on the basis of committing a tort or a conversion while acting in the role of agent for the company with the creditor being the wronged third party.²¹ However this doctrine requires some act which goes well beyond commercial misjudgement such as fraud, in order to make a successful claim against the director personally.²² The doctrine is however more of an awareness of the potential conflicts that may occur between creditors and the corporation near insolvency and is not to be viewed as a signal for direct action by a creditor.²³ The duty of directors towards the creditors changes as the corporation moves towards insolvency, increasing, to reflect and hopefully fulfil the attitude to risk intrinsic to the creditor's position.²⁴

The debate concerning how the conceptual extension of directors' duties is to be achieved, will reflect the philosophical understanding of the concept of the company²⁵. This extension will have to challenge the presumptions made about the concept of the company and the role of the board of directors²⁶. How this is achieved in legal terms will be looked at in the following

²⁰ In the Australian case of *Walker v Wimborne* (1976) ALJR 446, Mason J. stated that in a group of companies the directors of company A owed a duty to the shareholders of that company, as well as the company itself, and did not owe a duty to the other companies in the group. The marrying of the two distinct groups; shareholders and creditors, in the same conclusion illustrates that the courts were prepared to perceive the value of the creditors as equal to that of the shareholder and to impose upon the directors, a general duty towards them.

²¹ See "Does a Corporation's Board of Directors Owe a Fiduciary Duty to its Creditors?" *Beveridge St. Mary's Law Journal*. 1994. Vol 25:533.

²² In particular it has been used in conjunction with Sections 4-5 Fraudulent Transfer Act 1984, which provides that insolvent debtors defraud their creditors if creditors do not receive adequate value in exchange for transfers.

²³ *Supra* 14 and *Clarkson Co. Ltd. v Shaheen* 660 F.2d 506 (2d Cir. 1981), cert. Denied, 455 U.S. 990 (1982).

²⁴ For further reading see "Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors", Laura Lin, (1993), *Vanderbilt Law Review*, Vol 46: 1485, p1485.

²⁵ *Post* 53.

²⁶ *Supra* 1.

chapters but clearly any attempt to make objective the standard of care which will be required for a director either solely or as part of a board, will have to be circumspect recognising that the concept of risk inherent in the perspective growth of any corporation. This will not always lend itself to the establishment of a particular commercial morality or the production of an objective moral code²⁷.

These challenges have not detracted from the restricted ambit of the director's performance as a trustee of the corporation.²⁸ The company may have received separate legal identity under the principle illustrated in *Salomon v Salomon & Co. Ltd.*²⁹, but in the eyes of the Victorian lawyer, the corporation was referred to as "they" rather than "it". "They" (meaning the shareholder) would be responsible for the director's appointment, and "they" would be liable if the director turned out to be incompetent.

It is reflecting this closeness which the Victorian and Edwardian lawyers chose to maintain the idea that the director's duty was owed primarily to the corporation but that this meant to the shareholders as a whole whose legal powers had lead to his appointment.

Two cases in the early part of the twentieth century which illustrates this attitude to the relationship between shareholder and director are *Re Brazilian Rubber Plantations and Estates Ltd.*³⁰ and *Re City Equitable Fire Insurance Company Ltd.*³¹. In these cases, the emphasis on the standard of care and skill expected from the directors was determined by his own abilities to perform and not to subject him to an objective paradigm.

As Romer J. stated :

"It is indeed impossible to describe the duty of directors in general terms whether by way of analogy or otherwise. The position of a director carrying on

²⁷ Supra 13

²⁸ Sealy "Directors "Wider" Responsibilities - Problems Conceptual, Practical and Procedural. Monash University Law Review [Vol.13 September '87].

²⁹ [1897] AC 22

³⁰ [1911] 1 Ch 425

³¹ [1925] Ch 407 (Court of Appeal).

*a small retail business, is very different from that of a director of a railway company... In one company, for instance, matters may normally be attended to by the manager or other members of the staff that in another company are attended to by the directors themselves... The manner in which the work of the company is to be distributed between the board of directors and the staff is in truth a business matter to be decided on business lines."*³²

These cases are the basis for what has become almost an ambivalent attitude towards changing the overall standard of care to one which implies a more professional responsibility³³. It also disenfranchises other groups within the corporate nexus to whom it is felt a director ought to owe a duty of care³⁴. Basing a standard of care on the decision in *Re Brazilian Rubber*, the director would be liable for acts of negligence and gross negligence but the standard employed in determining whether the director was liable for either was that of the reasonable man and not the reasonable director³⁵. For the reasonable man, a lack of understanding of the area in which the director was trading would mean that there was no necessity to be good at your job. This meant that no professional concept of a 'director' was presumed.

If a director acted negligently in a large corporation because he had no experience of such a corporation then he was safe so long as he acted honestly. Such an amateur view of the director was acceptable on the basis that only the shareholders who appointed him would lose out as a result of the director's incompetence. This is no longer the case.³⁶

Thus the criteria for assessing director's liability for tortious acts is subjective and not objective which would imply that the director in tort is a professional person. This was

³² *ibid*

³³ Finch "Who Cares about Skill and Care?" (1992) 55 MLR 179.

³⁴ Parkinson "Corporate Power and Responsibility", Chapter 3. In particular, Parkinson looks at broadening the basis for the establishment of corporations to include the duties to employees and society as well as the more traditional groups, to establish the idea that the corporation becomes a good person within the community it operates.

³⁵ Neville J Supra 15.

³⁶ See post

illustrated in the case of *Hedley Byrne & Co. Ltd. v Heller & Partners Ltd.*³⁷.

However, the principle in *Hedley Byrne* has been illustrated in the case of *WB Anderson & Sons v Rhodes*³⁸. Here where a third party asked the defendant buyer for a credit reference for a mutual client the court held that the company was liable for the negligence of its manager and buyer when the information given caused damage to the third party.

The claim failed against the buyer and the manager because the former had only acted on the information given by the manager and the manager did not know for what the information was to be used. However it seems implicit from the judgement that had the manager known the purpose of the information he would have been liable³⁹.

Problems are inherent for the optimistic third party who wishes to rely on this case to enforce a judgement against the director who negligently misstates. First the principle will only arise where the director's advice is made in the context of the business or profession of giving that advice or where he has held himself out as being competent to give that advice⁴⁰.

Thus the position is that there is still no general duty in law or equity which requires the director of a company to meet a professional standard of care to a third party. This factor was underlined when in 1982, The Supply of Goods and Services Act expressly exonerated directors from having to act with reasonable skill and care under Section 13 of that Act. Rather what the director states or does not state, does or does not do, will result in him being legally responsible only once the nature of his actual job, work

³⁷ [1963] 2 All ER 575. This case established the principle that where a special relationship arose between the two contracting parties and one party suffered damage as a result of the other's negligent misstatement, damages could be awarded to the person relying on that statement.

³⁸ [1967] 2 All ER 850.

³⁹ Stanton and Dugdale "Recent Developments in Professional Negligence - iv :Directors Liability (1982) 132 New Law Journal 251.

⁴⁰ *Mutual Life & Citizens' Assurance Co. Ltd. v Evatt* [1971] 1 All ER 150. The majority decision in this Privy Council decision was stated by Lord Diplock.

contract and the client with whom he is dealing has been assessed.⁴¹ Also that the relationship with the party is such that the law or some device which influences the law demands that the director ensures full disclosure of the correct information.⁴²

However where the director is an executive director and he is under a contract of employment, then he must give the company the benefit of any professional knowledge concerning the corporation. Any third party who loses out as a result of any breach of this duty however will invariably sue the corporation and not the director.⁴³ This means that where the director is acting as an employee of the company, the company, in its contractual position with the third party will be liable for the negligence (and no doubt pay for the damage through its insurance), and the director will not be liable. Should the action be based on the director's failure to comply with his contractual obligations then the director will be in breach of contract. This fact was illustrated in the case of *Lister v Romford Ice & Cold Storage Co. Ltd.*⁴⁴. This however does not alter the position at common law concerning the director's general duty of care and skill.

The director can still find himself liable for damages even after these restrictions. In the case of *Williams & Another v Natural Life Health Foods Ltd & Another*⁴⁵, a director was so liable to a purchaser where he gave misleading advice about his own experience with a health care franchise he was selling, and the purchaser had relied on this advice. In this case the courts stated that the plaintiff had to show that there was a special duty owed by the director which went beyond the usual contractual duty. In giving advice

⁴¹ *ibid.*

⁴² *Supra* 3.

⁴³ *Sealand of the Pacific v Robert C McHaffie Ltd.* ([1974]) 51 DLR (3d) 702). Here the court emphasised that the director would only be liable where a duty was owed separate from the company. Where there was a breach of the contract based on the negligence of the employee, then that constituted a breach of contract viz. a viz. the company, and not the director.

⁴⁴ [1957] AC 555.

⁴⁵ *The Times*, January 9th 1997. This decision was reversed by the House of Lords on April 1st 1998 where a more conservative view of directors' duties to purchasers for mis statement was concluded. Here the distinction was made between information which the director gave in the capacity of a director, from which there would have been a duty, and information

about the potential profits which could be made the director had not mentioned that the profits were of that particular sum because of the fact that he as the vendor owned the shop from which he traded and therefore the overheads were lower.

The importance of this decision is that the director can be made personally liable where, as in this case, the company had become insolvent and thus unable to pay compensation. It also further broadens the basis for personal claims against the director which will have a preventative effect on the director who wishes to be manipulative in his position. In the US, manipulation was the focus of the decision in *Davidowitz v Edelman*⁴⁶. Here, directors who delegated a decision on whether the board of directors should be personally liable to shareholders for loss of corporate assets had summary judgement in their favour denied because the special committee dealing with the question of liability was not made up of independent parties⁴⁷.

The net result for the director is that he faces greater exposure to personal liability. As a result of this directors may increase the Director and Officer (D&O) liability insurance cover. The standard wording for this covers:

"...loss arising from a wrongful act in the capacity of a director"

and does not cover:

"breach of any professional duty owed to any third party"

which will prompt the director to act in a professional capacity when dealing with a third party. Any breach of this duty will be covered by professional indemnity insurance.

given as a vendor from which no duty arose even where there were unreasonable omissions in those statements.

⁴⁶ 583 N.Y.S.2d 340 (Sup. Ct. 1992).

⁴⁷ The importance of this decision is that it underlines the court's commitment to looking at the reality of the situation and not following blindly the structures which albeit legitimately created have an underlying objective at odds with general principles of commercial reality.

Clearly there is still a grey area which exists illustrated in the *Williams* case as to what type of indemnity should cover that particular scenario. A director's duty of care and skill will result in personal liability where he has acted beyond his position as director, but this does not mean that any knowledge which he gained in his personal capacity will be an inherent part of duties in the company.⁴⁸ The question of insurance keeping the director's duties at a professional level, are undermined by the fact that the insurance is curative. The thrust of law and regulation relating to director's duties has been preventative.

The directors and officers liability insurance further strengthens the principle that unless a director has a particular professional capacity, he is in fact not a professional at all. This in many situations will create an expectation gap between the director and others in the corporate nexus.

The position of trust together with the almost *ad hoc* evolution of directors' duties, has meant that any extension of directors duties has to reconcile the fact that if the director does have a duty to the shareholder it may well be at the expense of another group in the corporate nexus. Thus where the extension of the duty has been made, the extension has to carry with it qualifying conditions.

In the case of *Coleman v Myers*⁴⁹ for instance a director was held to have a duty to the shareholder, but not simply because of their relationship. There had to be something more. The closeness of the company, the dependence of the shareholder on the director, the existence of a relationship of confidence, the significance of the transaction to the parties and the extent to which the director promoted the specific transaction,

For further discussion see Liability of Professional Officers and Directors, Kirsten Thompson, (1993) Tort & Insurance Law Journal.

⁴⁸ Dugdale "Directors' negligence: new horizons". Tolley's Professional Negligence. 1997 Vol 13 No.4

⁴⁹ [1977] 2 NZLR 225

were deemed to be factors which would broaden the scope of the director's duty to the shareholder⁵⁰.

The reasoning in this case has been replicated in the decision of *Ebrahimi v Westbourne Galleries*⁵¹. Here the underlying personal relationship between the directors who were also the major shareholders in this "quasi partnership" meant that the dismissal of one of the directors justified the winding-up of the company. His position in management became an integral part of him remaining a shareholder and to oust him as a director was to undermine that presumption. The case indicates that the concept of the corporation and the duties exercised by those within it can be altered to respond equitably to the factual scenario of different types of company.

A more recent example of extending the duty to shareholders is found in the case of *Heron International Ltd. v Lord Grade*⁵². Here, the qualification for extending the duty to shareholders was that a take-over was taking place and the directors owed a duty to the present shareholders to obtain the best possible price. The court's presumption that in such a situation extending the duty to only current shareholders has been viewed as too restrictive and that in measuring the future performance of the company, directors should also consider future shareholders⁵³. In doing this the directors would be forced to think about the mid to long term performance of the corporation rather than its immediate profit.

To promote the benefit of one of the groups in the present or indeed future corporate nexus is perhaps a balancing act which invariably will engender discontent from those

⁵⁰ *ibid.*

⁵¹ [1973] AC 360

⁵² [1983] BCLC 244 (Court of Appeal)

⁵³ See ante Chapter 5. In particular, the reaction of directors to the fact that performance and not profit is the most important part of the objectives. This suggests that management is aware that the corporation is not two dimensional with the objective of making a profit, and that they do in fact have responsibility for the corporation as a diverse implement for those who are affected either directly or indirectly by it.

who see their position compromised by that other group. In this respect the directors' duties are more circumspect if as Lord Greene stated :

*" Directors must exercise their discretion bona fide... in the interests of the company, and not for any collateral purpose."*⁵⁴

This simple formula worked adequately in the nineteenth century where corporate structures were simple and the shareholder could state that his interest in the corporation were effectively being managed by his trustee ; the director. Today however the economic reality is different. The perspective on the position of the corporation as an institution and directors as protagonists have shifted to one more sensitive to public opinion and social welfare⁵⁵.

The importance of using the trust principle here is that it gives the court the opportunity of creating flexibility. Where measures concerning the extent of the directors' duties have proven draconian, changes to reflect the commercial reality of the day are made. For instance in the case of *Aberdeen Railway Co. v Blakie Brothers* ⁵⁶, the agency principle was strictly applied by the courts in finding that a director could not be a party to a contract with a company when he had an interest in that company. Here Lord Cranworth LC, emphasised the potential conflict which would arise from the objective of good management board to obtain the lowest price for any quantity of goods which the company purchased with the objective of any director to ensure that the company in which he had an interest made the best profit.

The presumption of an interest constituting a conflict was however refined in the case of *Northwest Transportation Co. Ltd v Beatty* ⁵⁷. Here the court was prepared to allow the company shareholders to ratify the director's contract with a company in which he had an

⁵⁴ *Re Smith & Fawcett Ltd.* [1942] Ch 304 at 306.

⁵⁵ See Berle "Corporate Powers as Powers in Trust" 1939 Harvard Law Review 1049. Here the importance of equity in the background to modern statutory remedies for inter alia shareholders, is considered in the debate as to how the development of these principles should be made. In commenting on the courts interpretation of statutory remedies however, it is imperative that judges invoke the equitable principles of trust to apply definitions to the law.

⁵⁶ (1854) 1 Macq 461 (House of Lords).

⁵⁷ (1887) 12 App Cas 589 (Privy Council)

interest but also afforded the minority shareholder the right to bring an action if the ratification was for an improper purpose. Flexibility was created between the need to protect the shareholder while ensuring that no draconian inhibition was placed on the corporation's ability to make a profit. Ratification can be seen as perhaps the most potent measure available to directors to prevent them from being subject to personal liability for breach of duty.⁵⁸

The position concerning the director's interest today, is illustrated in S.317 Companies Act 1985. Initiated by S.199 Companies Act 1948, it allows the director the opportunity of dealing with a corporation in which he has an interest if he declares the interest first. This provides the other directors and shareholders with an opportunity of concluding whether or not the director in question should be allowed to vote on the issue, or if he was in fact acting for his own benefit and not that of the corporation. In the case of *Guinness Plc v Saunders*⁵⁹ a consultancy fee of £5.2 million could not be kept by one of the directors, Mr Ward, because he had not disclosed the fact that he would have a particular interest in the contract which gave him the opportunity of providing the consultancy to the correct body in the corporation.

The nineteenth century cases created legal standards which have been built upon in the form of new legislation⁶⁰ and non-statutory regulations⁶¹. The basis of these principles is that the directors armed with great autonomy particularly in larger corporations may be tempted to circumvent his legal obligations namely that the director must act bona fide in the interest of the company, and to exercise such power for the 'proper purpose' for which it was intended.⁶²

⁵⁸ "Limiting Directors' Liability : Ratification, Exemption and Indemnification", Centre Point at The Centre for Commercial Law Studies Queen Mary and Westfield College, University of London. Edited by Ross Cranston.

⁵⁹ [1990] 2 AC 663 (House of Lords)

⁶⁰ See Chapters Two and Three ante.

⁶¹ See post Chapter Seven and also The City Code on Take-overs and Mergers which illustrates the extra duties of disclosure which are imposed upon a director when the company is facing a take-over. These duties are to the shareholder (*Re Chez Nico* ante) and illustrate the problems for directors who wish to keep their position in the company, but who are likely to face dismissal as a result of a take-over (see post Chapter Six).

⁶² *Hogg v Cramphorn* [1967] Ch 254 [1966] 3 All ER 420 (Chancery Division). In this case the court concluded that the improper purpose of the directors was capable of ratification

The main challenge to these principles has come from the change in the corporate structure. Today, 48.4% of companies are classed as small⁶³ with a further 0.5% being of medium in size⁶⁴. Such a large tranche in the corporate field has meant that in certain circumstances, the presumptions that have been made in the eighteenth century to the corporation are now anachronistic.

DIRECTORS DUTIES AND EMPLOYEES

Amongst the evolution of directors duties to shareholders and creditors is the more controversial issue of a duty to employees. The attitude of British management to the inclusion of employees in management is illustrated in the ambivalence shown towards those directives which have proposed in the European Community.⁶⁵ This ambivalence is a product of a traditionally uncircumspect attitude to employees which has resulted in a pro shareholder attitude which prioritises that group against the interests of the employee.

The British approach has been to introduce legislative measures designed to protect the interests of the various groups within the company from director mismanagement. These measures include a duty owed to creditors⁶⁶, employees⁶⁷ and minority shareholders⁶⁸. These sections share no uniform objective but accumulatively they suggest a broadening of the philosophical concept of the commercial trading company.

by the shareholders, implying that the latter was to be the check on the actions of the directors.

⁶³ Source is the DTI : 'Companies in 1994-95.'

⁶⁴ The definition of small company is inter alia found in S247(3) Companies Act 1985 and include (i) a turnover of £2.8 million or less (ii) a balance sheet total of £1.4 million or less (iii) 50 employees or less. For medium sized companies, the position is £11.2 million or less, £5.6 million or less and 250 employees or less respectively.

⁶⁵ See post Chapter Eight.

⁶⁶ The provisions in sections 213 Insolvency Act 1986 and Section 214 Insolvency Act 1986; fraudulent and wrongful trading. These concepts have extended the notion of personal liability to the director and create an objective standard of care for director activity. For criticism of these sections see ant Chapters 2 and 3.

⁶⁷ Section 309 Companies Act 1985. See post

⁶⁸ Sections 459-461 Companies Act 1985. See post

The duty to the employee, in section 309 Companies Act 1985 states that:

“(1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company’s employees in general, as well as the interests of its members.

(2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and to the company alone) and is enforceable in the same way as any other fiduciary duty owed to the company by its directors”

The section illustrates the recognition of directors duties lying in trust for the company and that the duty imposed is an extension of the traditional position of the director’s relationship with the corporation. However, the section as been criticised as “toothless” for while compelling the director to act in regard of the employee it still subjects it to the overall duty to the corporation. The result is that where directors have acted in the interest of the employees, it will open them to protest from shareholders who see the duty as mitigating their profit⁶⁹. However in the case of *Re Welfab Engineers Ltd.* ⁷⁰, Hoffman J held that a company’s directors had not acted improperly when they sold the company for a lesser price to someone who was prepared to take on the existing employees. The application in this case was from the liquidator, and the peculiarities of the case may prevent it from being a basis for creating a general duty.

The section indicates an awareness for the increase in directors’ duties to the employees, but this is a provision which remains ambiguous in its application, joining an implicit judicial conservatism towards the extension of the directors’ duties⁷¹.

⁶⁹ An example of the friction that a duty to employees can develop is illustrated in the case of *Parke v Daily News* [1962] Ch 927, [1962] 2 All ER 929. Here a payment to employees who were to loose their jobs, was successfully challenged by a shareholder, who saw that this would deplete the company’s assets leaving less for the shareholder once the company had been dissolved. The intention of the directors, was to provide a form of redundancy before the legal right of redundancy was initiated.

⁷⁰ [1990] BCLC 833.

⁷¹ See Boyle and Mordsley. ‘The Companies Act 1980 (4)’ (1980) *The Company Lawyer* 280 and Xuereb ‘The jurisdiction of industrial relations through company law reform’ (1988) 51 *MLR* 156.

THE TRADITIONAL VIEW UNDER CHALLENGE

The groups within the corporate nexus which are closest to the directors have seen their legal relationship with the director alter and the debate concerning more changes has gained momentum as the interest in director activity continues to accelerate. Apart from pressure from different groups within the corporation, the courts have also begun to look at certain circumstances which will alter the traditional duty of the director.

The view that the director owes a duty solely to the corporation has already been undermined in part by the non-statutory regulations on take-overs and mergers⁷² and by the concept of 'quasi partnership'⁷³. The problem for further development in this area, is trying to establish a set of legal principles which reflect the expectations of those which constitute an integral part of the corporate nexus, as well as developing a new agenda for the concept of the modern corporation⁷⁴.

In evolving a formula to achieve these objectives, principles of agency, contract, restitution, tort, statute and non-statutory regulation have been developed. The conceptual problem has however indicated that the basis upon which further development will take place is itself subject to debate. Should the process extend those principles of equity and trust to different groups in the company and beyond, or should the concept of the corporation be re-interpreted so as to develop the extension of these duties as an integral part of the corporation as a legal unit⁷⁵.

⁷² Supra 3

⁷³ *Ebrahimi v Westbourne Galleries Ltd.* [1973] AC 360, [1972] 2 All ER 492 (House of Lords). Here, the close nature of the corporation meant that the directors had a duty to Mr. Ebrahimi to ensure that he would remain part of the directorate, or that he would be bought out, or the corporation wound-up.

⁷⁴ For a selection of writing on this point, see Lord Wedderburn, "The Social Responsibilities of Companies" (1985) 15 M.L.U.R 4

⁷⁵ See Supra 55 and Dodd "For Whom are Corporate Managers Trustees?" , 1932 Harvard Law Review 1145, and Berle "For Whom Corporate Managers Trustees" 1932 Harvard Law Review 1365.

The following chapters will consider in particular the function of non-legal codes to establish an objective standard for the director. Berle amongst others⁷⁶ has indicated that leaving the development of corporate governance to self regulating codes is to trust in the altruism of the directors and is not as appropriate as legislation.

⁷⁶ Supra 54.

CHAPTER 7

CADBURY AND THE CORPORATE GOVERNANCE DEBATE

The issue of corporate governance is the issue which represents that gap between ownership and control of the company, which necessitates exacting directorial standards of excellence, and ensuring that the interests of the shareholders are kept at the apex of company policy¹.

However, the term shareholder is too limited for those who prefer the ambit of the company to reflect more diverse interests, such as employees, creditors and society generally. These groups have their nexus in the corporation, hence the wider concept of 'stakeholder'. The aim of balancing these interests is reflected in the divergent aspects of the Companies Act 1985, relating to employees (section 309) and the Insolvency Act 1986, relating to creditors (sections 213 and 214 amongst others).

To disregard those aspects of the company which furnish a true definition of the company's ambit as a commercial entity is not to understand the basic legal structure of the company. Even the shareholder is a generic term for a fluid group of people for whom the directors act not just on the basis of the present grouping but also for future groupings².

The debate concerning the issue of corporate governance is provocative for those who see its whole remit as undermining the underlying philosophy of free trade³. To admit too much statutory governance to the market is seen as inhibiting corporate freedom which, through the

¹ W. Carl Kester "Industrial Groups As Systems of Contractual Governance", Oxford Review of Economic Policy, Vol 8, no. 3, 1992.

² John W Mayo, "Corporate Governance and Directors Liability", The In-House Lawyer, April 1993.

³ Daniel R Fischel, "The Corporate Governance Movement", Vanderbilt Law Review, Vol. 35, no.6, November 1992.

objective of wealth creation, permits its own form of corporate governance and ensures the efficient activity of directors.

Such a scenario is not universally held and the decline in US company performances in the past ten years has led to a call for an increase in the amount of statutory regulation to be employed to ensure that companies become more competitive⁴.

The change from a 'laissez-faire' attitude to corporate governance to one in which both Parliament and the courts intervene has the problematic balance of meeting the needs of those shareholders who demand that company policy be more readily available for their inspection while keeping those aspects of directorial privilege and autonomy which are required for good corporate management⁵.

The cultural background for corporate governance in the UK commercial markets has been contextualised with the high number of take-overs during the 1980s. The importance of the take-over factor cannot be underestimated. The consequence has been to provide the markets with a device which prompts directorial efficiency, even though this may only be for the period which directly precedes the take-over and post merger empirical research has been critical of the economic efficiencies achieved. The perspective of the director becomes one known as short-termism.⁶

For the British market this has meant that the turnover in the number of directors in large corporations has been considerably high. Between 90-95% of company executives are changed within the two year period after the take-over⁷. The UK markets have produced four

⁴ Martin Lipton and Jay W. Lorsch, "A Modest Proposal for Improved Corporate Governance", 1992, *The Business Lawyer*, Vol. 48, p 59.

⁵ Ira M Millstone, "The Evolution of the Certifying Board", *The Business Lawyer*, Vol. 48, August 1993, 1485.

⁶ "Takeovers" John Steadman. 1993 Longmans. LONDON.

⁷ Tim Jenkinson and Colin Meyer, "The Assessment: Corporate Governance and Corporate Control", *Oxford Review of Economic Policy*, Vol. 8, no.3, p 1.

times the amount of take-overs than that of Germany which has had an almost negligible amount of hostile take-overs since the Second World War.

Another factor which has influenced the desire for better corporate control, has been the number of shareholders in the market which has risen from 3 million in the late seventies to over 10 million by the early 1990's⁸. With this increase has come a rise in the public interest of company management. Again the debate about shareholder intervention surrounds the desirability of the shareholder to actually involve himself in the running of the company. For Fischel⁹, the debate concerning shareholder intervention does not provide a suitable response to the objective of widening shareholder numbers and using that group in the corporate governance debate as a watchdog. Too many shareholders enter the market with the expectation that the company will be controlled by the directors and the Board and their position is to remain passive.

There are several reasons for this passivity amongst private investors. Certainly the law presumes that the shareholder is in the position of ultimate sanction, as with a majority vote at the GM, he can dismiss any director¹⁰. However, the practical restrictions significantly reduce the power. First, the shareholders may not be able to come together to form one voice to vote out a particular director¹¹.

Second, finding a venue big enough to cope with the particular vote may prove difficult for the company, although this may be circumvented with the use of tele conferencing which has been held to constitute a meeting¹².

⁸ Stanley Wright, "Two Cheers for Institutions", Social Market Foundation 1994.

⁹ Supra 3.

¹⁰ This provision is found at s303 Companies Act 1985. A meeting has to be held in order to execute the provision, which has proven a mitigating factor in the power of the shareholder.

¹¹ This problem has been met in the US with shareholder groups coming together on certain issues to prevent the management from selling out to a particular company. The formulation of these groups are a product of the general evolution of broad based share ownership and represent an increase in confidence for the shareholder.

Thirdly, it may prove politically damaging for the directors, or indeed the board, to be sacked. This would have an adverse affect on the share price again intimidating the shareholder from acting towards the director.

Finally, the shareholder may be outvoted by the institutional shareholders who act in greater harmony with the board as beneficiaries of 'soft' information which acts as an incentive not to be too rigorous with the overview of directorial activity¹³.

Nevertheless the issue of governance for the private shareholder who uses a nominee or who acts for himself is at the vanguard of the governance debate in Britain¹⁴. The major issues are who is to fund the cost of the increased information to be received by the shareholders, and perhaps more onerous, what that information is to be.

For the orchestrators of corporate regulation, these factors have meant that three major issues are to be reconciled in the search for effective and efficient corporate control¹⁵. The first is the cost of implementing any system of corporate governance. This is important in determining the overall profitability of the company, as a high degree of agency cost, which is the cost connected with the role of management implementation structure, will eat in to the profit costs of the company.

The second is finding an appropriate role for the shareholders in company monitoring. The diversity of ownership and control, was initially highlighted in the famous debate between

¹² *Byng v London Life Association Ltd.* [1990] Ch 170, [1989] 1 All ER 560 (Court of Appeal).

¹³ See post. Also note that in 1994, British Gas awarded a controversial pay increase for its chief executive, Cedric Brown. At the GM, the split between the institutional investors, who voted in favour of the increase and the private shareholder who did not, was marked. This dichotomy is a further illustration of the expectation gap which arises between the shareholder and management, in cases of profit relating policies and corporate accountability.

¹⁴ See DTI, "Private Shareholders : Corporate Governance Rights.", A Consultative Document, November 1996.

¹⁵ Prof. D.D. Prentice "Some Aspects of Corporate Governance Debate", *Contemporary Issues in Corporate Governance* 1993.

Berle and Means¹⁶, who recognised that in the growth of shareholder numbers their capacity to act by themselves as an efficient mechanism for directorial control was limited.

Thirdly, there is the structure and function of the board itself to be determined. The balance of power and the use of sub-committees and monitoring boards, have been suggestions for effecting a more accountable system of corporate management¹⁷.

Within these objectives, the aim of corporate governance is to create longterm successful business operations which are in the interests of the company as an entity and not one particular group within the corporate nexus¹⁸.

For commentators like Dodd¹⁹:

“...assumption of social responsibility by industrial leadership necessarily means assumption of such responsibility by corporate managers.”

However, the manifestation of such responsibility in terms of the acceptance of greater regulation, is subject to social and political dogmas which extend beyond the issue of corporate governance. For example, the move for greater environmental protection is to be balanced with the over-burdening of companies with compliance to expensive ‘green’ mechanisms of waste disposal and manufacture.

This problem shows that corporate governance is often a term used by a particular class of corporate membership to justify protecting the particular interests of that class. To overcome this problem, any code wishing to represent the true nature of corporate governance must first fulfil that balancing act which prevents it from being heralded as a poodle of any particular interest group.

¹⁶ Inter alia 1932, 45 Harvard Law Review, 1145.

¹⁷ supra 1.

¹⁸ supra 2.

The answer for most commentators has been to look to the Boards for greater accountability and structure in the system of corporate governance, as these provide the managers of the company with guardianship based on an objective to ensure the protection of the shareholders. One recent example of a Board changing from a passive acceptance to managerial supremacy to active intervention occurred in General Motors, which acted as a watershed for the restructuring of high powered quality Boards²⁰. Such a Board was felt to provide "that vision thing" which would instil into the company the competitive edge which the broad entity of managerialism could not provide. The result of this would be to make more cohesive the triad relationship of shareholder, Board and manager.

As Chancellor Allen stated in the Delaware Court of Chancery²¹:

"The conventional perception is that Boards should select senior management, create incentive compensation schemes and then sit back and watch the organisation prosper. In addition board members should be available to act as advisors to the CEO [Chief Executive Officer] when called upon and they should be prepared to act during a crisis: an emergency succession problem, threatened insolvency or an MBO proposal, for example."

He concludes:

"The view of the responsibility of membership on the board of directors of a public company is, in my opinion, badly deficient. It ignores a basic responsibility, that of the duty to monitor the performance of senior management in an informed way. Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the long-term strategic, financial and organisational goals of the corporation and should approve plans to achieve these goals; they should as well engage in the periodic review of short and long term performance according to plan and be prepared to press for correction when in their judgement there is need²²."

¹⁹ "For Whom are the Corporate Managers Trustees?" E. Merrick Dodd Jnr. 1932. Harvard Law Review. Vol XLV No.7. p1145 at p 1162.

²⁰ Supra 6.

²¹ Chancellor William T. Allen, Delaware Court of Chancery, "Redefining the Role of the Outside Directors In An Age of Global Competition, presented by Ray Garrett Jr., Corporate and Securities Law Institute, Northwestern University, Chicago (Apr.1992). Taken from "A Modest Proposal for Improved Corporate Governance" Lipton & Lorsch, 1992, The Business Lawyer; Vol. 48, November 1992.

²² Chancellor William T. Allen, Delaware Court of Chancery, "Redefining the Role of Outside Directors In an Age of Global Competition", presented by Ray Garrett Jr., Corporate and Securities Law Institute, Northwestern University, Chicago, April 1992.

Commentators have recognised that while this did not automatically lead to good corporate governance, it did act as a safety valve if the company was under performing²³. There were also limitations on the board's effectiveness which were attached to the size of the board and the means for implementing the views of the shareholders. The role of the strong Chairman/Chief Executive, also inhibited the board from taking a strong line on corporate policy.

Proposed changes in the United States prior to the initiation of the UK's Cadbury Report (detailed below) looked at the duties of the different members of the company with the hope of making the way clear for boards to determine the scope of their responsibilities and to end the ambiguities which up to that time had compromised their role as corporate governors. Some of those responses were translated into the British proposals for changes in the corporate governance of companies.

In response to the present deficiencies in the current systems of British corporate governance, Sir Adrian Cadbury chaired a committee whose findings were finalised in a report entitled, "The Financial Aspects of Corporate Governance" (1992)²⁴, which has suggested methods of achieving those standards of behaviour which at present are being circumvented by the inadequacies of amongst others, the insolvency provisions on the policing of directors²⁵.

The Committee was set up in May 1991, by the Financial Reporting Council of the London Stock Exchange, to address those aspects of financial governance which were vulnerable to the exploitation of The City's' barons, which had and have since included Nadir and Maxwell, for example. In that respect the Code like the Insolvency legislation of 1986, was a response to the current issues of corporate governance, rather than the product of a clearly defined policy

²³ Supra 5.

²⁴ 'The Report of the Committee on The Financial Aspects of Corporate Governance' was first Published 1st December 1992. It was chaired by Sir Adrian Cadbury. See Appendix 3.

²⁵ See Chapter Four.

on financial regulation,²⁶ thus a reactionary tone and a strong sense of urgency pervaded the proceedings.

Although the committee aimed its principles at public companies, it was hoped that the regulation it promoted as an indication of commercial good practice would eventually filter through to the larger private companies and even beyond that.²⁷ The committee realised the importance of the company to the economic drive and efficiency of the nation, and saw the Code, as a way of making those institutions strengthen their internal controls and thus make them more accountable to the public²⁸.

The Code proposed by Cadbury splits into four main sections dealing with:

- a) The structure of the board. Paras 4.1 - 4.6
- b) The role of the non-executive. Paras 4.10 - 4.17
- c) Directors remuneration . Paras 4.40 - 4.46
- d) Reporting controls through the establishment of an effective audit committee²⁹. This involved the directors reporting to the company that it was complying with the Code. Paras 4.33 - 4.38.

The Code's basic principles, were sensitive to the needs of balancing openness in the company while at the same time protecting information which would be sensitive to company's commercial integrity (para 3.2). It also saw the need to reflect this openness in a more integral report on the company's performance, by improving the quality of information received by the company from the directors, auditors and accountants (para 3.3).

The Code also felt that there was a need for companies to establish a more structured company framework which will allow it to be more efficient, in the passing of information from one

²⁶ Supra 2, Chapter One, Fletcher "The Genesis of Modern Insolvency Law-An Odessey of Law Reform".

²⁷ The Cadbury Code. Para 3.1

²⁸ The report of the committee on "The Financial Aspects of Corporate Governance", The Cadbury Report, December 1992.

²⁹ "Restoring Trust and Confidence in the Corporate System", Sir Adrian Cadbury, Opinion. [1992] 12 ICCLR, p 403.

body to another (para 3.4). This was not to implement a new structure for the company, but to build upon the existing structure and in doing so make it more responsive to the needs of the directors and shareholders³⁰.

The Committee hoped that this would achieve two things. First, it would raise the level of confidence in Boards by making them more responsible to shareholders and creditors, through furnishing those two groups with clear and accurate reports on company strategies. This would increase confidence in the Board. Second, that this standard of behaviour would be best achieved if those who were incorporating the Code could show to the rest of the commercial world that the standard practise did have a positive effect on the running of the business (para3.6).

The basic objectives of the Code illustrate the recognition in the commercial world that to disclose everything about the company's welfare is not in the best interests of the company and thus its shareholders and creditors. However, to reply to any criticism that this could be used as a means of circumventing the Code, the Code recommended that it be revised and kept up to date with accounting standards, so that the company's strategy for ensuring the best communication to its members, be of the most dynamic in form, if not in content (para 3.13).

Board Structure and Content

The committee stressed the importance of the structure of the Board in establishing a sufficiently high calibre of personnel and performance (para 4). The report advocating the Code, saw as a prerequisite to the establishment of a higher standard of practise, the initiation of a training scheme which would establish greater professionalism (para 4.19 & 20). This is a

³⁰ "A Critical Analysis of The Recommendations of the Cadbury Committee" Christopher Stanley, *Journal of Financial Regulation and Compliance*, Vol. 2, no. 1, June 1993.

recognition that the role of director is a professional one even though it is not designed with the furbishment of a professional examination analogous to accountancy or law.

Wrongful trading's position in this context is to be compared to a solicitor sitting L.P.C. exams at a time when a negligence suit is pending.

The Cadbury Committee supported new courses for directors, which will provide guidance on areas of recommended practice illustrated in the report. Pro-Ned, for instance, the champion of the non-executive director, has published a comprehensive set of booklets which give a guide to the successful implementation of Audit Committees, and Remuneration Committees (post), as well as providing a general guide for non-executive directors; their responsibilities and duties³¹.

The objective was to establish a balance of power which would prevent one person from having an "unfettered power on decisions"³².

The non-executive director was seen by the Cadbury Report as an essential element to Board control (para 4.10). Research undertaken by Pro-Ned³³, illustrated that there is too much informality in the appointment of non-executive directors. Of those non-executive directors appointed, only one-third had received a formal letter of appointment, and two thirds of appointees, took their position with insufficient knowledge and understanding of what was expected of them³⁴.

A BIM survey in 1972 found that most large companies saw the role of the non-executive directors :

" First, as a guarantor to the shareholders that the company is being run in a reputable and competent fashion and, second as an objective force able to

³¹ Pro-Ned "Promotion of Non-Executive Directors", Information File, 1993.

³² Comment On Cadbury Report, News Section [1993] 2 ICCLR C-35, Jane Ballantyne.

³³ Pro-Ned 10th Annual Review, September 1992.

³⁴ Ibid, commentary of Sir Adrian Cadbury.

*offer the board independent advice and criticism on general policy and specific subjects such as salaries."*³⁵

The expectations of the non-executive director have thus been recognised for some time as being central to the policing of the company - "Great Expectations" ³⁶was the title of a lecture by Sir Owen Green made in response to Cadbury. It was as a result of this that the institution Pro-Ned was initiated in 1982, on the initiative of the Bank of England, with sponsorship from a group of institutions "representative of industry and finance".

The report sought to utilise this perceived power by advocating a Board in which the executive and non-executive members would complement each other, requiring more careful selection of non-executive directors. This would lead to greater integration of the non-executive directors, and create an atmosphere of being an integral part of management rather than a separate entity. The search should thus begin with the objective of finding someone to fulfil a task rather than choosing a prestigious name.

Nevertheless, the main aim of such a scheme is to establish independence in non-executives, and to decrease the "old boy" network which Pro-Ned revealed constitutes some 60% of non-executive appointments. This is seen as compromising the concept of a professional non-executive in favour of a mentality which is only interested in whether the individual will fit into the general ethos of the company. The net result of this is the creation of an "in-house" mentality more disposed to self-congratulation than of establishing a sound independent check on the activities of the Board.

In their guide for the effective non-executive, Pro-Ned points to several areas to which the non-executive should pay attention³⁷. The structure of the organisation should be examined to

³⁵ Reported March 1972.

³⁶ The lecture was entitled "Corporate Governance : Great Expectations" reported inter alia The Times 25th February 1994. Here he criticises the ability of the non executives to act as a complete response to the question of remuneration , demanding full disclosure of director's pay.

³⁷ A Brief Guide to Recommended Practice on Non-Executive Directors, Pro-Ned file on information 1993.

discern the relationship between one unit and another, thus providing the non-executive with an overview of the planning and decision making process of the company. This will afford the non-executive ample scope in deciding when that process is not being used and to discover if there is a sinister reason for this.

There should also be full understanding of the system of financial control in the company so that the non-executive can indicate whether they are satisfactory, in the Annual Report. This is designed to create greater efficiency, and for the same reason, to develop an awareness of markets for the company's products would provide the Board with individuals who could assist on targeting company promotion³⁸.

The use of the non-executives to fulfil such an important advisory capacity in corporate management has negative as well as positive motivations. While the non-executive can effect a more structured construction to board policing, the fact that he and not the company's other advisors such as solicitors and accountants are being promoted, illustrates the difficulty with keeping company employees independent when they are being paid by the board³⁹.

The position of the non-executive is also subject to the problem of their loyalty to the company compromising their role as an effective independent policing entity. Pro Ned stated in its code (1987) that independent non-executives could best be achieved by a professional adviser "not being retained by the company" and who is "not a significant customer of or supplier to the company."

The guides issued by Pro Ned illustrate a move towards greater assistance in corporate governance with the objective of greater management supervision and efficiency. Similar advisory bodies are also underway for the general directors of companies with the backing of the Bank of England, the CBI, and the Institute of Directors. Such courses are currently being

³⁸ A Practical Guide For Non-Executive Directors : (Janet Morgan Pro-Ned Conference 1993).

³⁹ Supra 17.

run by Sunbridge Park and Egon Zehnder. The aim of these courses is to establish a basic knowledge of company procedure from which a director can like his legal counterpart enter the large, specialising multinational or the small high street firm.

This training would also discipline the company director to reading those journals, which would keep him up to date with developments in company law, and any procedural changes he would have to implement in order to stay in line with standard practices.

Indeed determining standard practice has itself been open to much debate. Perhaps one of the most important aspects of the report is the requirement that companies report on the effectiveness of their system of internal control (para 4.5 of the code). A working party established to deal with the criteria in the report reached its 17th draft before asking that the committee be given more time to debate the salient points. This has meant that companies have waited to implement this provision until the guidelines have been clarified⁴⁰.

More recently The City has witnessed one of its most dramatic company failures, when Queen Moat House Hotels collapsed with losses of over £1 billion. In a report published by the company accountants in May 1996, examining the problems which the company was facing, a complete replacement of non-executive directors was seen as vital for the viability of the company to continue, and that the company structure for dealing with board meetings was completely inadequate⁴¹. It recognised the importance of the non-executive board as a policing body in the company, and at QMH, this meant a complete change of the existing non-executive directors⁴².

Nevertheless, the approach of using the non-executive as a corporate regulator is open to criticism. Firstly, while the code issued by Pro Ned focuses on the structure and objectives of the non-executive, it does not give substantial guidelines as to how those objectives are to be

⁴⁰ Cadbury Requirements: Internal Control, David Pimm, *The Administrator*, October 1993, p 29.

⁴¹ *The Sunday Telegraph*, 27th February 1994, Patrick Weaver, 29th November 1993,

fulfilled, or how the non-executive will get his point of view imposed upon the board. Also, there is no distinction at law between the executive and non-executive director, which makes the establishment of different duties for both seem inappropriate.

In the Australian decision of *AWA Ltd. v Daniels* (trading as Deloitte Haskins & Sells) and Others⁴³, Rogers C.J. Comm D., took great care to distinguish the legal expectations of the chief executive and the non-executive. He commented on the role of non-executive directors:

*"in contrast to the managing director... are not bound to give continuous attention to the affairs of the corporation. Their duties are of an intermittent nature to be performed at periodic board meetings of any committee of the board upon which the director happens to be placed. Notwithstanding a small number of professional company directors there is no objective standard of the reasonably competent company director to which they may aspire. The very diversity of companies and the variety of business endeavours do not allow for a uniform standard."*⁴⁴

Suggestions for the improvement in the capacity of non-executives, have included a clear definition of their role in the company. Since the Cadbury report, the role of the non-executive director has grown in importance, but this has not been reflected in legislation recognising the distinctive role of the non-executive⁴⁵. Such a definition would inevitably lead to greater formation of recognised standards of care for the non-executive.

To ensure that the independence of the non-executive is maintained, there would be a limitation on their fees so that they would not include benefits such as pension rights which would prompt them to be less independent in their analysis of the company's performance. With such a heavy responsibility placed on the shoulders of the non-executives; discerning management resources, forming management structure and dealing with a host of sub-committees, the problem for companies will be finding people of sufficient calibre to undertake the task successfully⁴⁶.

⁴² The Times, 29th November, 1993.

⁴³ (1992) 7 A.C.S.R 759; 10 A.C.L.C 933.

⁴⁴ The Duty of Care of Non-Executive Directors, Sally Sievers, September 1993, Company and Securities Law Journal, p 321.

⁴⁵ City Comment, Stephen Rosefield, 1993, 90/41 Law Society Gazette, p 34.

Other recommendations are that the number of non-executives in PLC's should not be less than two and not more than six, as any more would dilute effectiveness and influence. To enhance their profile in the company as a decision making unit, they should be able to circulate their views on company policy at the company's expense. This is indicative of a more general view of where the cost of corporate governance ought to be met.

Further proposals are that the non-executives be elected every two years and that there should be an annual comment from the non-executives to the shareholders on the policy decisions of the board.⁴⁷

To complete their position in the balance of company power, the DTI, the Bank of England, the Stock Exchange the Securities and Investment Bureau (SIB) and other bodies acting under the Financial Services Act should be required by law to bring directly to the attention of the non-executive any misconduct in the company.

However, the controversial nature of these provisions would be strongly resisted by management who see them as being too restrictive. The code for the non-executives as well as these recommendations can act as a useful guide for legislation, but in this respect also show the problem of enforcing a regulatory code and whether the only real solution would be legislative measures.

Cadbury: Reforming Board Structure and Remuneration

Further proposals of the Cadbury Code suggested the decentralisation of power at board level, ensuring that the offices of Chief Executive and Chairman, be separated (para 4.9). The role of the Chairman is to ensure that the board is run properly, and that shareholders are fully aware

⁴⁶ *ibid.*

⁴⁷ Cadbury Code paras 4.16 & 4.17

of those aspects of the board agenda which require their approval⁴⁸. Thus the role of the chief executive, augmented by having the power over these aspects of board control, would lose the discretion to implement policies without the necessary approval of shareholders, through delaying those administrative aspects of the company designed to give effect to efficient shareholder notice. This will provide redress for mismanagement, but its objectivity is mitigated by the ability of the shareholder to be circumspect to the other interests in the corporation, such as employees and creditors.

In the decision of the DTI into the affairs of Blue Arrow plc,⁴⁹ one of the major criticisms of the company, which had successfully taken over the Manpower Inc., was the amalgamation of the role of Chairman and Chief-Executive, in the hands of Tony Berry. If the power of this one individual had in fact been reduced, it has been suggested that the governance of the company would have been improved, and that the costs relating to Blue Arrow's involvement in the Blue Arrow Challenge for the America's Cup, would have been scrutinised by the board, and less controversial⁵⁰. In this particular instance, Berry was able to commit the company without the shareholders or any other stakeholder being able to discuss the policy.

This particular aspect of Cadbury however, has been criticised by those that see the separation of the two roles as undermining strong leadership which is felt to be necessary for effective company management⁵¹.

Sir Adrian Cadbury has fielded these criticisms by arguing that the debate on the effectiveness of board structure has now been opened and that this was one of the most important objectives of the committee⁵².

⁴⁸ Shareholder passivity has resulted in this aspect of governance being eroded in practice. However, the need for communication with shareholders has been highlighted most recently, in two reports, "Private Shareholders: Corporate Governance Rights" A Consultative Document DTI November 1996 and "Shareholder Communication at the Annual General Meeting; A Consultative Document", DTI, April, 1996.

⁴⁹ "The Blue Arrow Report", DTI, September 1992.

⁵⁰ Blue Arrow. Lessons on Corporate Governance, Helen Shilling, Practical Law For Companies, June 1993.

⁵¹ Commentary in 'The Times' by Matthew Lyn and Rufus Olins, 27th June 1993.

Nevertheless, in the years succeeding the implementation of the code, a number of the major companies have split the roles of Chairman and Chief-Executive. These including Ladbroke, Kingfisher, Pearson and Reed, underlying the recognition of its importance in the establishment of a more effective board.

The balance of power in the board was felt by the committee to be best consolidated by establishing stricter procedural requirements for board meetings (para 4.23), and for the establishment of new sub-committees dealing with amongst other things, directors remuneration and auditing.

The Cadbury Committee felt that the character of remuneration would keep company personnel, including non-executives objective and independent. It was suggested that remuneration for non-executives should not include share options or pension schemes. This would effect a distance between the non-executives and the commercial interests of the company, thus affording greater scope for criticising objectively any failure of the company to act in accordance with the Code of Practice which Cadbury suggests.

Concern for what is seen as the excesses of director remuneration has increased, criticism coming from shareholders and the Association of British Insurers. The criticisms of the ABI show that the incentive for higher performances, should be justified by a long-term performance scheme of at least three years, and that options for the purchase of shares should phased in to encourage a longer involvement period with the company. In the same vein, remuneration committees should specify that the directors retain their options for at least three years, and that investments from bonuses should be kept for a similar period⁵³.

⁵² *ibid.*

⁵³ The Times, 25th May 1994 Martin Flanagan, and 'The Independent', 25th May, Louise Randell.

The Cadbury Code suggested that remuneration be dealt with by a remuneration committee, which would be managed under the auspices of the non-executives (para 4.42). In this way the newly independent non-executives would be able to restrain the excesses of directors and validate their remuneration by constant dialogue with the shareholders.

A survey carried out by 'The Times' for 1993, showed that in spite of the recession, the number of executives that had taken a pay cut of more than 10% was only 5%, the number of executives who had received a pay increase of over 10% was 41%, indicating the lack of sensitivity to the commercial markets, trends in director's pay illustrated⁵⁴.

A further indication of the compromises that can be made of the effectiveness of remuneration committee was seen in the Body Shop's decision to award the managing directors, Mr and Mrs Roddick, a pay cut of some £150,000, for the financial year ending April 1996⁵⁵. While ostensibly this seemed to be a way of capping the pay of directors, it belied the fact that the Roddicks along with only two non-executive directors constituted the remuneration committee, and that the effectiveness of the committee was subject to the will of the two major directors. A pay cut seemed less gracious in view of the fact that as the two major shareholders, they also received dividends increasing their income to almost £1 million each.

The capability of the shareholder to act as a restraint on the directors is limited to the matters on which they are routinely called to vote at the AGM. These include receiving and considering the Annual Reports and Accounts for the previous year; to declare a dividend; to elect directors appointed by the Board since the last AGM or re-elect other directors; to authorise directors to fix the auditors remuneration; to appoint or re-appoint the auditors; and to authorise directors to issue new shares, for cash within the constraints agreed by the institutions' Investment Protection Committee⁵⁶.

⁵⁴ London Times Business Section, report by Phillip Bassett, 14th July 1993.

⁵⁵ Reported inter alia, 'The Times', June 1996.

⁵⁶ Supra 17.

These items tend to be retrospective in their content, and do not allow the shareholder to involve himself in the policy decisions of the future. However in Table A, shareholders perform in theory an integral part of the decision making process for director's remuneration⁵⁷.

The ability of the shareholder to influence the remuneration of directors was illustrated in the case of *Guinness Plc v Saunders*⁵⁸. Here, one of the directors, Ward, was promised a payment of £5.2 million, on the understanding that the bid to take over Distillers Plc proved successful. Later, Guinness argued that the payment had not been authorised and sought to recover the payment. Ward argued that the power had been delegated to the committee, but the House of Lords rejected Ward's argument, stating that 'the power to grant remuneration lay with the Board and not a sub committee'⁵⁹.

The importance of illustrating the Articles' central role in authorising the power of the Board to decide on the remuneration of the directors, means that theoretically, the shareholder can alter the articles at any time to take away that power. The problem for the shareholder is forming the requisite majority to alter the articles⁶⁰. This problem has all of the hallmarks of the shareholders general handicap in creating an effective police force within the corporation⁶¹.

Nevertheless, shareholders are the obvious beneficiary from the legal requirement that authorisation has to occur before remuneration can be validated. The underlying rule of equity also precludes directors from receiving payment on any other legal basis where there has not been due authorisation, and the equitable doctrine of "quantum meruit" which was argued by

⁵⁷ Article 82 provides that the shareholder will determine the remuneration of the directors at the AGM. For the managing director, the position is dealt with under Article 84, and is the remit of the board to decide.

⁵⁸ [1990] 2 A.C. 663.

⁵⁹ See in particular the provisions of Articles 90 and 91, Table A.

⁶⁰ Section 9 of the Companies Act 1985, requires a special resolution (75%) of shareholders to approve the alteration, which can then be challenged by 15% of the minority shareholder. The alteration can also be subject to judicial intervention, on the basis that alteration was not in the interests of the corporation. (See inter alia, *Dafen Tinplate v Llanelli Steel* [1920] 2 Ch 124). These particular problems beset the shareholders exercising their powers granted under Article 82, Table A.

⁶¹ See ante Chapter 5.

Ward in the Guinness case was rejected by the House of Lords⁶². The cases were distinguished on the basis that the Boardman case did not result in a conflict of interest with application of the rule whereas in the Guinness Case there was an obvious conflict which occurred as a result of Ward trying to obtain a particular result for the company and having an input into the decision on his remuneration package once that objective was obtained⁶³.

For the directors, a lack of authority in granting remuneration, will result in personal liability for any loss to the corporation and the corporation being free from liability. The shareholders can still go on to ratify any such award⁶⁴. For the Board however, shareholder protection can be undermined if there is a liberal judicial interpretation on what constitutes an authorised process. In the case of *Runciman v Walter Runciman Plc.*⁶⁵, directors were allowed to act informally in extending the chairman's contract to five years even though a formal board meeting was required to do this, because there was nothing in the articles specifically stating that the board had to meet formally. The result for the shareholder is that such flexibility may be manipulated by those who would wish to take advantage of a 'Guinness' type scenario.

The case validates *de facto* the use of committees to do the work of the board. It did not matter that some of the directors had not given their formal approval to the amendment to the Chairman's contract. As Simon Brown J states:

*"[their] involvement went beyond mere informal acquiescence...when they were acquitted with the proposal following approval by the non-executive directors they, as directors, had the opportunity to query them. The mere fact that they never apparently did so and that their views were not more explicitly canvassed seems to me nothing to the point: by the time of the implementation of the various salary increases, and more obviously still by the time [R] came to assert his notice term, such terms were indeed "as determined" by the other board members and none of them could have been heard to assert the contrary."*⁶⁶

⁶² See ante at 42. The principle of "quantum meruit" was established in the case of *Boardman v Phipps* [1967] 2 A.C. 46.

⁶³ See speeches [1990] 2 A.C. 663, 689 (Lord Templeman), 701 (Lord Goff).

⁶⁴ See "Director's Remuneration: Constraining the Power of the Board. Andrew Griffiths. *Lloyds Maritime and Commercial Law Quarterly*. August 1995. Part 3.305-432.

⁶⁵ [1992] B.C.L.C. 1084.

⁶⁶ [1993] B.C.C 220 at 223.

The Companies Act provides for the director to have his remuneration policy scrutinised for any “hidden agenda” it may entail. This is achieved by compelling the director to disclose any interest he may have in a particular vote (inter alia a vote concerning a remuneration package). Section 317 Companies Act 1985 requires a director to make it his statutory duty to “declare the nature of his interest at a meeting of the directors of the company”⁶⁷.

The effect of the section was illustrated in the case of *Guinness*⁶⁸ where the House of Lords did not treat the terms of the enabling article which provided for a self dealing vote on the basis of prior disclosure as a condition of the board’s power to award remuneration, but rather as a condition of the enforceability of the award by W. Thus failure to disclose a personal interest in the remuneration does not make the decision void, but instead makes its enforcement voidable.

In *Runciman*⁶⁹, Simon Brown J concluded that the statutory duty of disclosure applied even where the interest of the director was obvious to the other directors, and failed to recognise that such an obvious interest as voting on the amendment of your own service contract, could act as an implied disclosure of your interest. Nevertheless, Simon Brown J concluded that on the balance of justice, the board’s decision should not be set aside, even though it was voidable, because it would provide the new controllers of the company with an unexpected gain, which was a product of the omission of a legal technicality. To allow the new owners to benefit he declared,

“would be to sacrifice [R’s] legitimate interests on the altar of slavish adherence to ritualistic form”.⁷⁰

⁶⁷ Schedule 4 Companies Act 1989 requires the notes to the accounts to disclose the aggregate of director’s emoluments received during the relevant financial year. This includes emoluments received in connection with any subsidiary. A separate disclosure is required for the Chairman of the company. The notes must disclose emoluments in bands of £5,000.

⁶⁸ ante 46.

⁶⁹ ante 53.

⁷⁰ ante 64

Once again the case provides an example of the attrition that often exists between the efficient running of the internal structure of the corporation and the corporation's legal responsibility to its shareholders and other groups in the corporate nexus⁷¹.

The economic consequences of directors' pay influence the input of the incentive remuneration in the overall remuneration package⁷². A too liberal package which does not include incentive, will prohibit the director from taking any lucrative risk with the corporation. However, too motivated a package, will detract from the director reinvesting and developing in the corporation seeing the prospect of a greater dividend as a prerequisite to his 'bonus' salary⁷³.

The overview of judicial discretion may result in an inconsistent approach to the difficult decision of looking at the legal duties as opposed to the commercial expediency of the corporation⁷⁴.

The balancing exercise, however, can be seen as needing to uphold the duties of public policy for which such statutory provisions were created. In the instant case, the only reason for holding the meeting was to discuss the alteration of [R's] contract, and thus the disclosure of his interest would it is argued be superfluous to the rest of the directors who would have known about his position.

⁷¹ The bad publicity of conflict in the shareholder's input into determining the pay of director's was particularly illustrated in the Cedric Brown case in British Gas. Here, the smaller investor and the institutional investor were split in their respective disapproval and affirmation of the pay rise.

⁷² Directors and Officers Remuneration: The Role of the Law. I. Ramsay. *Journal of Business Law*. July 1993.

⁷³ P.M. Dechow and R.G. Sloan, "Executive Incentives and the Horizon Problem : An Empirical Investigation (1991) 14 *Journal of Accounting and Economics*" 51.

⁷⁴ See Tim Pryce-Brown "Directors in Company Asset Transactions", *The Company Lawyer*. Vol. 16, no.7, July/August 1995. The article explores the strict legal requirements relating to the purchasing and selling of assets between directors and the corporation and focuses on the decision of *Duckwari Plc v Offerventure Ltd & another*. Court of Appeal (Civil Division) 7 July 1994 (unreported). Here the provision of s320 on substantial property transaction was rigidly enforced even though the company like the instance case of *Runciman*, had changed ownership.

Nevertheless, the duties of law provide for the public to be protected from the unscrupulous behaviour of the director and not to adhere to those duties is to undermine the trust in the public corporation which is central to the relationship between the shareholders and the board.

In the case of *Neptune (Vehicle Washing Equipment) v Fitzgerald*⁷⁵, Lightman J held that the statutory duty of disclosure had three purposes. The first that all directors should know or be reminded of the interest. Secondly the making of the declaration should be the occasion for a statutory pause for thought about the existence of the conflict of interest and the duty to prefer the interests of the company to the directors' own. Thirdly, disclosure or reminder must be a distinct happening at the meeting, which therefore must be recorded in the minutes of the meeting under section 328 Companies Act 1985⁷⁶.

With the rise in shareholder awareness in the activities of the board and the public policy duties of the corporation enshrined in the Companies Act 1985 provisions relating to disclosure, the momentum for any change in the law on disclosure would have to take account of the increased expectations of the shareholders and particularly those institutions which represent a large input of corporate capital, in public corporations.

Methods of improving shareholder control have suggested a wider ambit for shareholder involvement particularly in the approval of take-overs and the validating of dividends, where 75% of votes would be required before a dividend could be issued. This it is hoped would prompt the shareholder to be more pro-active in his commitment to the company and to realise that as well as rights he also has duties⁷⁷.

⁷⁵ [1995] B.C.L.C 352.

⁷⁶ For further discussion see inter alia, "Disclosure of Directors Interests", Richard Nolan, *The Company Lawyer*, Vol. 16, no.7, July/ August 1995.

⁷⁷ See inter alia, DTI Consultative Document on Shareholder Communication at the Annual General Meeting, April 1996. Also "Law Commission Paper 142 on Shareholder Remedies" 1996 which looks at changes in Section 459 Companies Act and related provisions to the concept of unfair prejudice.

However, such limitations would be controversial but if past by legislation, would not be inconsistent with the underlying philosophy of the free market, as it would not involve intervention by the Government but only by those who own the company⁷⁸.

The effectiveness of shareholders as a corporate police force, is seen as having its future in the form of the institutional shareholdings, held by the bigger financial institutions⁷⁹. This would introduce a new dimension into the role of those institutions, which up until now have seen their position as being that of administrators of share acquisition and not to oversee the conduct of the different boards with which they are dealing.

The advantage the institutions have concerning the policing of companies is that they have immediate and sensitive access to a wide range of companies. This would enable the institutions to command a panorama over company structure and performance, and to intervene in those companies which are not 'keeping pace' with the general standards of accountability and board structure being implemented by the other companies.

Two factors which mitigate the excitement for such a new panacea for the corporate governance lie in the relationship between the institutional shareholders and the board. Firstly, the institutions have no direct financial interest themselves in the companies, and even though their reputation depends on obtaining successful investments, the presumption cannot be made that the institutions will want to get too involved in the direct management of the company. As R.E. Artus, a leading investment manager stated:

*"any conceivable increase in [institutional] activity will not amount to a major new element of accountability in our system matching that of the bank-based economies, since share ownership unaccompanied by the additional involvement in providing finance and other services, will never provide the depth of knowledge and commitment that arises with the combination of banking and property interests."*⁸⁰

⁷⁸ Supra 17.

⁷⁹ J.E.Parkinson : Corporate Power and Responsibility, Chapter 6. Oxford Clarendon Press. 1993.

⁸⁰ R.E.Artus (Group Chief Investment Manager of Prudential Corporation plc) in "Creative Tension?" (1990) at 14. It has been suggested that institutions increase their holding in the companies to say 25% in order to increase the enthusiasm for company monitoring.

This factor is closely linked with the second. The 'soft' information which the institutions receive from directors of many of the boards allow for financial planning amongst the institutions. Such material, including the potential profit ratio of the company for the next two or three years, furnishes the institutions with advice which enables them to provide their principals with the most effective investment programmes, and such information would be difficult to lose, if the institutions became too inquisitorial into the way the managers of their information were actually conducting the management of the company.

One final element in the relationship between the shareholders and the company is the capacity of the smaller shareholder to no longer see his reaction to any discontent in the company as being limited to selling his shares; the 'Exit' phenomenon. In the USA, recent "voices" have been raised by those pension fund holders, to take-overs of the company. This change from the traditional passive role for the shareholders, to an interventionist part in the corporate triad, reflects the decline in the internal finance markets in the USA and the UK, and a greater need for the smaller shareholder.

This change of emphasis cannot therefore anticipate the former deference which stood at the forefront of the shareholder's relationship with the board⁸¹.

However, with this newly discovered political power, there is still the option of releasing shares at a financially unstable point in the company's life, which undermines the shareholder's capacity to monitor the company effectively. It has been suggested therefore that the information which is furnished to the shareholders by the company contains the long-term prospects of the company, which will make any decision to sell less servient to the short-term results of the company, and thus much less volatile.

⁸¹ Liquidity versus Control: The Institutional Investor as Corporate Monitor, John C. Coffee Jr, (1991) *Columbia Law Review*, Vol. 91, no. 6, p 1277.

The implementation of statutory limitation on selling shares is a more controversial but effective way of also ensuring the consistency of shareholder commitment to the company, which is a prerequisite for corporate control⁸².

Furthermore, institutional share ownership has witnessed an increase in its vocal concern for the remuneration of directors, and in particular concern lies in the area of the 'golden parachute' given to directors, should they be asked to leave the company before the expiration of their contract. For the NAPF (National Association of Pension Funds), this has been labelled as a "reward for failure".⁸³ However, if the rules relating to the director's contract on early release are implemented this may very well result in even a larger contractual claim for the corporation via wrongful dismissal.

This cost is an inhibiting factor to an early termination to the contract⁸⁴. The Cadbury Report went some way to ensuring that the bill for an early termination be limited by requesting that director's service contracts be shortened to three years unless shareholder approval was first sort and obtained⁸⁵. The Remuneration Committee and the disclosure requirements on all of the directors' emoluments are of course other elements to try and control the way in which directors are paid⁸⁶.

The Stock Exchange in its 1993 revised set of Listing Rules (aka the "Yellow Book"), extends the disclosure of directors' emoluments even further. It requires that the details of the directors' service contracts must include "full particulars of each director's arrangements for salary and other benefits", "any commission or profit sharing arrangements", and "any provision for early termination of the contract". This last provision must include anything which will enable the shareholder to estimate the liability of the corporation for early termination of the contract.

⁸² *ibid.*

⁸³ "Fair Shares?", Alexander Pepper, *Accountancy*, April 1995, p 158.

⁸⁴ *ante* Chapter Five.

⁸⁵ Cadbury Report, published 1992, Para 4.41.

⁸⁶ Cadbury Report. Paras 4.39 - 4.46.

Cadbury was further extended by the 'Yellow Book', when the recommendations of Pro-Ned, concerning the independence of non-executive directors who sit on Remuneration Committees, were complied made compulsory. Here in particular, the Chief Executive was felt to be a witness to the proceedings but was excluded from voting with the committee.

As well as the recommendations of the NAPF⁸⁷ to the subject of director remuneration, other institutions like the Association of British Insurers⁸⁸ (ABI) and Accounting Standards Board Urgent Issue Task Force (UITF)⁸⁹ have also made contributions to the future moulding of the remuneration of boards. However, it was the Greenbury Report⁹⁰, which has created the greatest amount of debate in this area.

Like Cadbury, the Greenbury recommendations were designed for large public companies, with a view to obtaining a code of best practice which would become a ruling for listing on the stock exchange⁹¹. The shareholder was seen as being central to the need to provide greater information on the subject of director remuneration, and for this reason, Greenbury felt it necessary to give shareholders an account of what compliance had in fact taken place⁹².

For Greenbury⁹³ the efficient use of the Remuneration Committee is an important aspect to the formulation and structural application of the director's remuneration. Remuneration Committees should be given the power to discharge those powers held by the board concerning the payment of directors, necessitating a change in the articles of association if required⁹⁴.

⁸⁷ The NAPF paper "Directors Service Contracts" was issued in December 1994.

⁸⁸ Report published in May 1994, entitled "long-term Remuneration for Senior Executives".

⁸⁹ Report was issued in September 1994, entitled "Disclosure of Director's Share Options".

⁹⁰ Report published on 17th July 1995.

⁹¹ Greenbury Report, para 2.1-2.5.

⁹² *ibid.*

⁹³ Code of Best Practice. The Greenbury Report 1995. Gee Publishing LONDON.

⁹⁴ *ibid.*, para 4.3.

Weaknesses in this process unveil themselves when the remuneration device for the non-executives, who exclusively form the remuneration committee are considered. Here, the Committee decided that this matter should be dealt with by the Board, and confined to the limits placed in the articles of association⁹⁵.

This format may be considered as a potential mitigating device in the effectiveness of implementing a structure which can satisfactorily be perceived as being objective and independent in its method of defining a policy on director remuneration. With their own salaries subject to the will of the Board (which may also alter any articles of association), the remuneration committee will have considerations about its own well being in the process of deciding the remuneration of directors, which may not be in the best interests of the shareholders.

The shareholder's position is further weakened as the Remuneration Committee, decides on an annual basis whether the shareholder's approval should be sought on the policy for remuneration in that year⁹⁶. The process is open to manipulation and extra policy consideration which may be very politically charged. The net result is that again in practice the role of the shareholder is undermined.

The disclosure and approval provisions within the Greenbury Report do go some way to invoking a broader perspective for the shareholder to have his views at least heard. The remuneration committee must not only disclose the full policy reason for remuneration to the shareholder⁹⁷, but the decision was taken in connection with the code of best practice⁹⁸.

Perhaps even more difficult for the board to explain, is the question of long term share options which may be granted to directors in one lump sum rather than phased over a period of time.

⁹⁵ *ibid*, para 4.13.

⁹⁶ *ibid*, para 5.28-2.32.

⁹⁷ *ibid*, para 5.4.

⁹⁸ *ibid*, para 5.25.

In this case, the board must explain and justify the awards to the shareholder⁹⁹. This goes on to raise the issue of how deep an explanation is required. In the report to the shareholders, the board may feel that a substantial share option award is justified on the basis that the director has worked hard, although controversially. The shareholders may disagree but may find the hard evidence of profit too great an argument to be off-set by other more socio-economic reasons for disallowing the award. There may also be a tendency to blind the shareholder with science in coming to the conclusion concerning the policy reason for the award.

It is clear from the British Gas plc decision to award Cedric Brown a substantial increase in salary, that the shareholder can be far from passive in his response to the question of director's pay. Nevertheless, with the influence of the institutional shareholder, and its relationship with the board, the small shareholder's voice is lost¹⁰⁰. The result is a frustrating expectation gap between the shareholder who wishes to be more active in the corporation, and the seemingly impenetrable board and institutional shareholder.

The Greenbury Committee's report highlights some of the considerations to be taken into account when formulating a policy on director's remuneration. Most importantly, is the commitment of the company to offer incentives that will attract retain and motivate directors of the quality required but paying more than is necessary for this should be avoided¹⁰¹.

This paragraph leaves the decision of what is necessary to the board, and clearly, this may result in a subjective and highly political interpretation being made. The report goes on to consider that the remuneration should reflect the performance criteria of the corporation as a whole¹⁰², and which compares with other similar corporations.

Finally, there is the matter of compensation payments for, inter alia, early termination for poor performance. Here, the Report preferred a shortening of director's contracts to one year, in

⁹⁹ *ibid*, para 6.29.

¹⁰⁰ *ante*, Chapter Five, and *The Times*, 1995.

¹⁰¹ *ante*, 70, para 6.5-6.7.

order to limit those contractual compensation payments which are necessary for early termination¹⁰³.

While this may limit the compensation payments for early termination and make the director more responsive to the issue of management it also encourages a shorter term perspective of the corporation's policy on reinvestment and development which may be viewed in deference to the over-riding objective of making a profit, in order for the director's performance to be viewed well by the shareholder.

The Greenbury Report, thus places emphasis on the use of the remuneration committee, to act as an independent monitor for the policies on directors' payments. The structure, while ostensibly applaudable, loses momentum when the inter-linked relationship with the board is considered. The non-executive's body Pro-Ned recommends that the remuneration committee deal with all aspect of director's remuneration¹⁰⁴. In expressing this wish the body would presume that the committee would act as an independent monitor for the shareholders and those other interested groups in the corporation. The structural flaws in its application however may well serve to mitigate the effectiveness of the committee.

Communication in the Company

¹⁰² ante, 70, para 6.38-6.40.

¹⁰³ ibid, para 7.11-7.18.

A further problem associated with the increase in shareholder activity is the extent to which communication is considered as an important factor in the successful execution of company policy, by the board. For it is the board which decides what information is given to the shareholders in the annual and six monthly reports. This is an area which Cadbury suggested more openness and far greater definition was felt to be needed in the responsibilities of accountants, auditors and directors. (Chapters 4.0 and 5.0 respectively).

Another criticism forwarded by Queen Moat's accountants focused on "the absence of consolidated management information...made it extremely difficult to identify trends or to interpret the overall financial position of the Group." Also directors were unable to furnish detailed papers of the half yearly profits for 1992. The company has been observed as having grown so quickly, that it had failed to ensure that an internal communication structure had grown sufficiently. The result was that management became unable to respond to the company's problems in the absence of efficiently produced information available for inspection in a timely manner.

Cadbury suggested that this be dealt with by an official agenda (see below). In the case of Blue Arrow¹⁰⁵ the lack of information concerning company policy resulted in a piecemeal approach to the whole issue of communicating to shareholders. This also deters the non-executives from fulfilling their role with greater integrity through furnishing them with complete information concerning the company's activities.

In the respect the Code also recommended stricter guide-lines on seeking professional advice. This was felt to be better orchestrated, by allowing the director to obtain that advice at the company's expense. This would also lead to more Board meetings, which would be structured by using the formal schedule of duties defining clearly the expectations of the company from the different managerial groups. Such codification, would contain the duties of the directors

¹⁰⁴ "Curbing top pay bonanza", Saleem Sheikh, *The Company Lawyer*, Vol. 16, no. 4, April 1995.

¹⁰⁵ *Supra* 39.

which would be placed in a statement before the auditors Report. The major consequence for the company is that it would give itself a check-list of items which it would have to raise at Board meeting to comply with an accepted form of practice undertaken by all companies. The Code felt that such a schedule would include the acquisition and disposal of company assets, and any capital projects which would involve risk, (para 4.24)¹⁰⁶.

The emphasis is clearly upon Boards making themselves more available to discuss matters which are of material importance to the company's financial position, and to establish a procedure for determining a particular matter as significant in ensuring that the company acts in accordance with the Code.

The report was also critical of the procedure for directors' appointments, and the principles upon which the appointments were made. In particular, it was felt that individuals were chosen for their personal suitability to the company's existing management rather than for their experience in company management, thus undermining the philosophy of the report to establish a professional class of directors.

To enable a more objective criteria to be employed when determining directors' appointments, the report suggested the establishment of Nomination Committees, which would have a majority of non-executive directors. The independent committee would be responsible for Board selection, and because of the independent nature of the non-executive Board, illustrated in its selection process (ante), this would lead to an objective criteria for selecting the new directors. The result would be more directors being chosen for their professional expertise, thus raising the standard of directors' practice generally.

The ambit of determining expertise and suitable candidates for management is still a contentious issue as the broad notion of corporation defines a considerably differing degree of commercial activity and thus a wide degree of expectation of directors from different groups in

¹⁰⁶ *inter alia*, Commentary by Ashurst Morris Crisp, "Director's Responsibility for Financial

the company. There have been a variety of committees and working groups which are trying to establish a standard of corporate management which would act as a blueprint for anyone deciding to trade through the means of a company¹⁰⁷.

Once this more efficient and better trained mechanism is put in place, the report suggested that it would provide greater opportunity for Boards to make more reports to the company, beyond that of the half yearly reports currently furnished. This would be extended to any significant intervening act which the Board undertakes. The Board, on these occasions, would meet with the Auditing Committee, to discuss the question of cash flow, for those future requirements finalised at Board level. Perhaps such a procedure would be the ultimate guard against any proposition that the company had not taken every step to minimise the loss to creditors - the defence to wrongful trading - by showing that it had frequent and detailed discussions with relevant parties, in relation to fresh sources of finance.

The Audit Committee

In connection with this new, more dynamic level of communication, is the report by the auditors. This report giving a true and fair view of the company's performance¹⁰⁸, is central to the responsibilities of the directors and auditors, to the shareholders, and the creditors. One of the problems for auditors is that in times of trouble they are left being scrutinised by all effected by the poor performance of the company, as to why that performance was not detected sooner, in the end of year report. The Cadbury Committee's report, expressed its concern with the expectation of the commercial community to the role of the auditor.

Statements", Practical Law for Companies, January/February 1994.

¹⁰⁷ Henley Management College are devising a booklet which deals with many issues which should be addressed by the director before he takes up his position on a board. Aimed at the middle sized company it makes representations on a wide range of issues from setting out the aims of a good board to overseeing the successful implementation of the of the objectives. The booklet is entitled "Good Practice for Boards of Directors", **date, publishers etc**

¹⁰⁸ Section 235 Companies Act 1985.

Clearly, an auditor is not an accountant who can work by himself in concluding the position of the company. His report is based on the information which is given to him by the company director. Shareholders however look to the auditors as being the safeguard of their interests. The auditors, will be helped in fulfilling this role, by the implementation of those recommendations already outlined, concerning the director's responsibility to communicating the company's current financial position.

However, the report also felt that an Audit Committee would facilitate greater enthusiasm, in protecting the shareholder's interests. At present two hundred and fifty listed companies use an audit committee. The main purpose of these committees, is to liaise with the external auditor about the half-yearly financial statement submitted to the Board, and to comment on any reservations arising from the audit without the executive board members present. This provides the company with a greater amount of openness and honesty when dealing with their auditors, which will have a positive effect on the position of the shareholder's understanding of the company's current position, and financial expectations for the coming period of trading.

The position of the shareholder's understanding of company matters is further strengthened by the report's desire to see greater director accountability. This would manifest itself by shareholders being allowed to submit written questions to the Board concerning company objectives and policy. In the age of popular capitalism, this would resolve the sometimes opaque argument that the shareholder is prevented from expressing an opinion because of the practical difficulties in holding a general meeting for such a large number of people. The main effect of this proposal is that shareholders will be able to comment on the strategies proposed by the Board. This fulfils a traditional and perhaps forgotten criterion that ownership and control of the company are not best married by being mutually exclusive ¹⁰⁹.

¹⁰⁹ *Supra* 74

Cadbury and the Corporate Governance Debate

The Code initially sets out standards for listed companies, but clearly the report envisages its guidelines being adopted on a much wider level, as their effect on company trading standards is realised. The success of this self-regulating report, depends upon the willingness of the commercial community to enshrine it into its constitution. A survey carried out by Manches & Co. Solicitors, suggests that the code is receiving mixed reviews from companies. Their corporate survey indicated that in response to the companies being asked if they would be implementing the Cadbury Code on Corporate Governance, stated:

	YES	NO
1. Appointment of an audit committee	85%	15%
2. Split of activities between chairman and chief executive	75%	25%
3. Appointment of independent non-executive directors	83%	13%
4. Three year maximum service contract for directors	84%	15%
5. All of the above four issues	57%	43%

Table 1: Results from survey conducted by Manches & Co. Solicitors 1993 by kind permission of Mr Stephen Goldstraw (19th November 1993)

These figures show that while the commercial community sees the advantage of more regulation in their company structure, it also shows that the code is viewed as being too inflexible, particularly in its demand for all of its suggestions to be implemented. The main reason for such qualified success is that companies see the code as being insensitive to the financial capabilities of the smaller listed companies to, in effect, re-structure to come in line with the code.

In analysing the effects of the code on building societies, The Building Societies Association (BSA), published its response to the Cadbury Report¹¹⁰. It welcomed the general thrust of the report, but pointed to a number of areas which it felt were inappropriate to the needs of building societies. In particular it felt that it was unacceptable to omit the chief executive from the audit committees altogether, as under Section 71(11) of the Building Societies Act 1986, the chief executive is required to sign the report of the audit committee, relating to compliance with the requirements concerning accounting records.

¹¹⁰ The Financial Aspects of Corporate Governance, produced 30th July 1992.

It also felt that the measures in section 6 of the report fostering a closer relationship between the shareholders and the board were inappropriate for building societies.

The report reflects the data in the Manches survey in that there are clearly a great many aspects of Cadbury which are welcomed by the different bodies effected by it. The criticism is based in the objectivity of the report in relation to those structural and procedural aspects of Cadbury. Yet, the BSA decided to issue guidance for governance which were in the words of its commissioner, Terry Matthews, "are as rigorous as those for companies"¹¹¹.

Those who have been central to the orchestration of the code will admit that companies openly criticise the report as being too intrusive. However they also recognise that privately owned companies are prepared to accept the report suggest in the light of shareholder pressure, raised public interest and peer group pressure. It now seems clear that companies will incorporate the code into their constitution, but only when it is economically expedient to do so. This will perhaps hamper the code's effect filtering through to the smaller listed and unlisted companies who will see it as being more expensive red tape.

The thrust of the code must not be to compromise the conditions which make the director enthusiastic to pursue a challenging entrepreneurial objective¹¹².

Clearly, the code is an attempt to move the philosophy underlining market morality to one of prevention rather than cure. The provisions in insolvency legislation come too late to keep a regular and diligent check on the activities of the directors and tries to establish a standard of behaviour at a time when the ramifications of mismanagement are translated into the economic adversity of the company. At that point the formula prescribed by Cadbury for effective corporate governance becomes obsolete.

¹¹¹ London Times, Business Section, report by Lindsay Cook, Money Editor, 2nd June 1993.

¹¹² London Times, Business Section, report by Pennington, 24th February 1994.

Challenges to Cadbury

In spite of the overall acceptance of the Cadbury report, it has faced a number of criticisms from those who see it as not going far enough to ensure shareholder control over directors performance¹¹³. In particular it is felt that remuneration of directors should be fully published and that directors should be re-elected every two years. Cadbury recommended three. Shareholder approval should also be required for take-overs, and at a General Meeting a resolution should not be passed valid until 75% of voters entitled to vote have done so, or their proxies have been considered instead.

These rather more draconian measures illustrate the importance placed upon the new political strength of the shareholder, and are quite naturally an anathema to those who traditionally have experienced autonomy within the company structure, the director.

For this group, the display of contempt for the report from amongst others, Sir Owen Green, illustrate that Cadbury is still not clear of those aspects of corporate management which it is felt are the ambit of the directors¹¹⁴.

Governance as Regulation or Legislation

The major advantage of implementing regulation through non-statutory means, is that it is quicker and cheaper, and provides a certain degree of flexibility in determining the scope of its ambit. For Cadbury, the detail of the committee's report and the rigidity of the structural and

¹¹³ Two Cheers for the Institutions, Stanley Wright, for The Social Market Foundation, 1994.

¹¹⁴ In a press release issued by the Institute of Directors in December 1992, an approval was made of Cadbury but only on the basis that the roles of the non-executive and executive director were not completely separate, undermining the unitary system of corporate governance. This factor alone has prevented any harmony in Europe on the question of corporate governance, and will be dealt with in the Chapter Eight.

procedural effects it offers, would seem to undermine these paradigms for non-statutory regulation.

The objective of such regulation, was to facilitate better financial reporting and not to initiate a complete overhaul of the corporate governance structure. In that respect however, Cadbury is again outside such limited expectations. So much of the regulation afforded by the code is prescriptive. The division of responsibilities between the chairman and the chief executive, the role of the non-executive, the length of the directors service contracts and the objective of making professional the whole concept of directorships. This has led commentators to suggest that a statutory response would be more appropriate¹¹⁵.

In particular it was felt that the objective of defining the different roles of the Audit committee, the non-executives and the executive directors would benefit from the extra gravity of the statutory model.

Critics of Cadbury argue that the code only applies to those large institutions that would not harm the public anyway. The result is that the Code becomes too thorough in its objective, but fails to cover those smaller institutions which would actually benefit from an increase in corporate governance¹¹⁶.

For those institutions which will circumvent the Code, with the hope of not being found out, the Code without the back-up of statutory penalty will be perceived as a soft centred and half hearted attempt to initiate higher standards of corporate procedure and accountability.

One way of establishing a compromise is to effect a more detailed code like that advocated by the Securities and Exchange Commission (SEC), with a much more interventionist approach by an overseeing body to the effective use of the code. Perhaps a hybrid approach would meet

¹¹⁵ Corporate Governance and Cadbury : Self-Regulation and Alternatives, Paul L.Davies and John P.Lowry, Journal of Business Law, January 1994.

those anxious to create more responsibilities for those professional groups which are used by the corporation. In particular, the more rigorous governmental role of the auditors would be placed in statute, while other aspects of the code would remain in its non-statutory form.

The Cadbury Code has been reviewed by the Hampel Committee¹¹⁷ to determine its effectiveness the changes needed. In its final report, the Hampel Committee emphasised certain recommendations in the pursuit of good corporate governance. These included a narrative in the annual report on how provision was being made to comply with broad principles of governance. The use of the word principles as opposed to rules recognises that to be prescriptive about the structure for good governance is to ignore the peculiar characteristics of each corporation. This failure was one of the criticisms of Cadbury.¹¹⁸ The emphasis for the report was to place responsibility for explaining how broad principles of governance in a particular corporation were being implemented in practice (para2.1). The route for each corporation would be different and application would apply flexibility with common sense (Chapter 7 para 2). A complementary device to the Listing Rules is envisaged by the report (para2.1).

The role of the non-executive is still perceived as the main device for Board control and the raised profile given to them by Cadbury while supported by the Hampel Committee nevertheless carries with it the caveat that non-executives have become too intrusive in their monitoring role.(para3.7) ¹¹⁹. Connected with this reservation is whether the non- executive

¹¹⁶ Financial Services Regulation-Time to Stop and Think ?, Dennis W.Cox, Butterworths, Journal of International Banking and Financial Law Journal, April 1994.

¹¹⁷ The Committee issued a series of questions concerning reforms of Cadbury in October 1996. The final report was published in January 1998: 'Committee on Corporate Governance' January 1998, Gee.

¹¹⁸ See ante.

¹¹⁹ The dangers of this materialising were envisaged by Cadbury which stated: 'The emphasis in this report on the control function of non-executive directors is a consequence of our remit and should not in any way detract from the primary and positive contribution which they are expected to make, as equal board members, to the leadership of the company' (Cadbury para 4.10).

director has too broad enough agenda when monitoring whether the board is taking into account the interests of others in the corporate nexus¹²⁰.

Remuneration of directors and the length of their service contracts, still remains at the forefront of concerns which the committee feels it has to address. The report makes it clear in its recommendations however that the company will not benefit from the director having a lengthy service contract and directors should seek re election every three years. (Chapter 7 recommendation 17). While emphasising the need for efficiency the report clearly supports the short term profit orientated objective for directors by taking away any security they may have in valuing a long term service contract.¹²¹

Expediently, the question of long term incentives being correctly regulated illustrates the need for balance between harnessing the effectiveness of incentives for the director which is for the best interests of the corporation, and avoiding the use of such incentives to ostensibly massage the salaries of directors which might not reflect their contribution to the corporation's well being.

The Hampel Committee is keen to maintain the status quo within the corporation, seeing no reason for an extension of the stakeholder corporation envisaged by the Labour Government.¹²² In particular, there has been no support for a strong code which will outline the role of the Chairman and the Chief Executive with a view to balancing power within the Board.¹²³ The

¹²⁰ The Hampel Report makes it clear that the role of the non executive is to assist in the strategy planning of the company and that this should be the priority for them over the role of monitoring. The independence of such non executives is supported (para3,8) but this may be compromised by the nature of how the non-executives are paid. See ante.

¹²¹ For a discussion on the entrenched position of Japanese directors who are brought up in a culture of long termism see Chapter One 'Keeping Good Company' Johnathan Charkham. Butterworths.

¹²² The relationship between the director and the shareholder is considered as being different from the relationship between the board and others in the corporate nexus because of the shareholder's residual power to hire and fire directors (para1.17). However it places firm restrictions on the involvement of the shareholder in, *inter alia* approving the remuneration report (Chapter 7 recommendation 32).

¹²³ Para 5.10 Hampel Report. Concern has come from *inter alia*, the Institute of Chartered Accountants. Here, Andrew Carey of the ICA has stated that while a rule book is not required

emphasis in the report throughout is on the level of information given to the shareholder which will afford him the opportunity of having an informed choice from which he can decide his own future in the corporation.¹²⁴

The role of the institutional shareholder is also raised and at present is being dealt with by the Department of Trade and Industry in its consultative document relating to the the more effective use of the AGM and the communication of the shareholder¹²⁵.

The response to the issues raised in Cadbury has illustrated a conservatism in the Hampel report. However the report does raise those important issues which will remain the focus of the governance debate. Importantly the role of the shareholder and the appropriateness of his involvement in corporate management and the role of the non executive in acting as a monitoring device for the Board. The problem of choosing appropriate levels of governance further illustrates the need for greater sophistication in corporate structuring before the imposition of governance structures can be made.

corporations should not be left with a "do it yourself" agenda when it comes to how shareholders respond to corporate policy . See The Times Wednesday August 6th 1997.

¹²⁴ *ibid.* The Times .

¹²⁵ *Supra* 42. The report clearly emphasises the need to ensure that with their power in corporate equity, institutional investors actively get involved in voting so that a void does not exist which emphasises Board autonomy in the corporation providing an imbalance of power (para5.7).

CHAPTER 8

EUROPE: WORKER PARTICIPATION IN MANAGEMENT AND THE GOVERNANCE DEBATE

The importance of the European perspective on the ambit of directors' duties and the expectations of the public and Government towards management practices is based in two related factors. First, there is the comparison to be drawn between the different cultural attitudes of the Continental countries to the role of the director and how this reflects the broader expectations of the company. Second, the EEC proposed Fifth Directive¹ and related directives reflect and even magnify the problems of the differing cultures to the role of the director in the company and the whole issue of corporate governance.

In making a comparison with other European countries towards the issue of corporate governance, it is possible to deduce that the conclusions reached would act as an appropriate paradigm for our own system of governance. This may also illustrate why there is such a divide between our expectations of the harmonisation of company law within the Member States.

THE GERMAN POSITION

The emphasis in German commercial culture is on the importance of co-operation. This has an historical base in the post-war ostracism which Germany felt acutely. The context in which commerce is undertaken is also influenced by the political background of Germany. Despite the right-wing politics of the Nazis, the attitude towards industry was rooted in a socialist objective of mass benefit, even though the ideal was subject to much abuse. The result of these attitudes

¹ OJ 1972 No. C 131/49. This was later amended (see post).

towards post-war commerce was to create a welfare orientated free market, which is long-term in both its objectives and its policies.²

One of the more obvious signs of this cultural characteristic is the structure of the company itself in Germany and the relationship between manpower and the management. Unions, while having their power emasculated during the past fifteen years in the UK, play an important role in the running of the corporation in Germany and works councils are compulsory for companies which employ over 100 employees.³ These entitle the employees to information on a wide range of corporate policy.

Within German public companies (the *Aktiengesellschaft*), co-operation is further illustrated by the composition of the Supervisory Board (*Aufsichtsrat*) which deals with, amongst other things, the composition of the Management Board (*Vorstand*). The Supervisory Board must contain an employee representation where the company consists of more than 500 employees and is a family company or where the company is a mining, steel or iron business of more than 1000 employees. Employee representation is also found in private limited companies, (*Gesellschaften mit beschränkter Haftung* - the "GmbH") or mining companies with over 2000 employees. These provisions were established between 1951 and 1972 in a series of "Co-determination Acts", which reflects the importance of the employee culture in the role of the larger, national corporations.⁴⁵

The employee element in the supervisory board often brings the board to life as it plays an active and indeed vigilant role in monitoring the activities of the Vorstand. It does this by reviewing policies adopted by the Vorstand three or four times a year at formal meetings of the board. The actual power of the Aufsichtsrat includes:

² Corporate Governance in Germany : Keeping Good Company. Johnathan Charkham. 1994 Oxford University Press.

³ See post.

⁴ Directors Duties and Responsibilities in the EEC : Germany. Hags Schimmelpfennig.

- i) Supervision of management⁶
- ii) Appointment of the management team⁷
- iii) Approval of the annual accounts⁸

Discussion concerning the role of the supervisory board, in light of the fact that there are no statutory guidelines to assist it in the fulfilment of its powers and obligations, centres on the fact that there is too much power with not enough accountability or indeed a sufficient regulating check on that power.⁹

The monitoring process in the German company is further strengthened by the fact that the number of smaller shareholders is considerably less than in comparative British and US companies. The structure of German company ownership is detailed in Table 1 below.

	1960	1970	1980	1990
Private Households	27	28	19	17
Enterprises	44	41	45	42
Public Sector	14	11	10	5
Foreigners	6	8	11	14
Banks	6	7	9	10
Insurance Companies*	3	4	6	12

(* this includes pension funds)

Table 1 - Company Ownership with Germany for period 1960 to 1990

⁵ These acts were respectively Montanmitbestimmungsgesetz 1951, Germany 2 (1954), Betriebsverfassungsgesetz 1952, Germany 6 (1955) and Mitbestimmungsgesetz 1976, (Cologne 1976).

⁶ Akt G para 111(1).

⁷ AktG para 84(1)

⁸ AktG para 171(2)

These figures contrast sharply with the percentage of smaller, institution represented investments which make up over 60% of public company equity in the UK.¹⁰ There are several reasons for the contrast. First, the state pension in Germany is relatively high so there is less demand for private pension schemes. In addition the pension system works on a pay-as-you-go basis which provides for no large capital sum upon retirement which can be invested.

Second, the German company treats its pension provision for employees as a long term liability and will only invest one third of the requisite value of the prospective pension fund in another company. The result is that there is less capital in the market to invest. If the company becomes insolvent and thus unable to pay its pensions, the scheme will be covered by the "Pension Guarantee Association", membership of which is compulsory.¹¹

Thirdly, insurance companies, which have a statutory investment ceiling in companies of 30%, do not exploit this investment potential and their aversion to risk is illustrated by the fact that investment levels are around 10%.¹²

The importance of this investment structure lies in the effect it has on the objectives of the company. The low level of smaller investors means that there is less emphasis on obtaining a dividend. This is particularly important in times of economic recession where the German company can continue to re-invest and develop monies which comparative companies in the UK and the USA will utilise to pay a dividend.

The cultural effect of this is to create a long-term focus within the company which can survive changes in the economic and political barometer. Connected with this is the high percentage of company investment directly with other companies. This creates an atmosphere of co-operation and not of competition which creates an added security for the company. It enables the company

⁹ See "Controlling directors the German way" J Shearman, (1997) *The Company Lawyer*, Vol 18 No.4.

¹⁰ See Chapter 5

¹¹ See *supra* 2 and *Industrial Groups as Systems of Contractual Governance*. W. Carl Kester. *Oxford Review of Economic Policy*. Vol. 8, No.3.

to achieve its main objective of going beyond the maximisation of company profit and towards investing in what is in the best interest of the company as a whole.

Another important characteristic of German corporate philosophy is the company relationship with the banks. Unlike the UK where banks are more disposed to take a charge over company property when granting the company finance, German banks get more involved in the company by buying equity in the form of shares. This means that the expertise in the banking community can be called upon as part of the company and not just as a reference in times of company difficulty. The closer relationship between banks and industry produces a more cautious and prudent policy towards company money, again more disposed towards long-termism.

This fact is illustrated in the accounting standards which are based on prudence rather than a "true and fair view".¹³ Such a philosophy has led to the creation of a reserve fund which is understood and validated by the Aufsichstrate.¹⁴

The co-determination principle based in the idea of a cross fertilisation of manager and employee works effectively in this area as it provides an atmosphere of circumspection within the company. This has generated a good management/staff relationship. However this has recently been under strain caused by the effects of the re-unification on German industry, in particular the effects of the financial markets attaining greater international freedom.

The effects of the in-house mentality is thus manifested in three ways: employee representation on the board; the closeness of the company's relationship with the banks; and the co-operation

¹² Supra 2

¹³ See post

¹⁴ The Aufsichstrate, or "Supervisory Board", is an integral part of the German governance model, and is designed to oversee the works of the Vorstand. In particular, it elects members to the Vorstand, and includes representatives from the different groups within the corporate nexus, including the controversial element of employee representatives. It applies only in corporations employing more than 1000 employees. See ante at 3,4 &5 and post.

between companies based on the tightly structured relationship of company ownership with other companies.¹⁵

The major difference this produces in any comparative study with the British system of corporate governance is the relevance of take-overs in the production of efficient management. In the UK, the threat of take-over has been central to the reactions of management to company policy. The short-term devices employed by company directors in Britain are to inflate the company's profits and avoid the company becoming vulnerable to a take-over. However, while these devices produce rich pickings for the short term speculator, they are also devoid of the consistency and endurance of the policies adopted by the German directors who do not have the constant threat of take-over.

There are several reasons for this contrast with British management. Firstly, because of their inter-relationship with other companies, German directors often find themselves on the supervisory board of several companies in the same commercial area. As there is a long tradition of this, the position of management becomes entrenched and the objective for a take-over mitigated. With the inclusion of the banks in the equation of corporate ownership, the corporate groupings suffer less conflict in determining the financial needs of one member of the corporate grouping.

The second reason, closely connected with the structure of corporate ownership in Germany, is the effect of the inter-relationship of companies on agency costs. The closeness of companies has led to contractual efficiency based on a more informal system of trust. With an interest in fellow companies, management is less likely to delay on contracts and open up to being sued for breach of contract. The informality also allows for greater flexibility in the contractual relationship between companies which means that they can be more responsive to changing commercial activity.

¹⁵ This structure is similar to the Japanese Keiretsu, in which a cross fertilization of corporate ownership produces a group identity with mutual interests in preserving the best performance levels for everyone in the group. For further reading see "Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization" Ronald J.

Thirdly, there is the effect of shareholders on the policing of the company. Unlike the diversity of ownership in the UK and the USA, ownership of shares by private individuals or families is concentrated. As a result it can be called upon to act as a more effective check on corporate power. The concentration of power by a small number of individuals can be seen as the source of creating a long term perspective which Germans have taken to investment.

The culminate effect this has on the German corporate board is to create a culture based more on reputation than form. This is the result of the informal approach to contract. Secondly, by a process of establishing a long-term culture in the working of the company, the German population, just like its British counter-part, has emulated the corporate ethos by ensuring that investment is long term. Thirdly, the socio-economic background to the German corporation has created a culture less disposed to the idea that profit alone is the sole objective of the corporation. In order to keep this tradition alive, the corporate managers, by the process of self-discipline, have created a culture which is less dependent on formal means of corporate governance.

Having established the cultural context of German corporate activity, it is important that the position of the banks is highlighted to demonstrate the underlying stability in German corporations which make them less prone to the British and American controlling device on corporate activity: the company take-over.

In 1984, banks in Germany's top 100 largest companies, held over 50% of company stock which constituted nearly 25% of the nominal value of German stock corporations.¹⁶ This gives the banks an entrenched power base in the corporation in view of the restrictions placed on other shareholders' voting powers

Gilson and Mark J Roe (1993) 102 Yale Law Journal 871-906, taken from *The Law of Business Enterprise* (editor Sally Wheeler) Oxford University Press 1994.

¹⁶ These figures were produced by Gottschalk, in data entitled "Deer Stimmrechtseinfluss deer Banking in der Aktionarsversammlungen fohn Grossunternehmen" (1988) WIS-Mitteilungen.

Under self-imposed company policy voted in by the banks in their capacity as shareholder, no shareholder may vote more than 5% of the company shares, regardless of the size of the actual share holding. In this respect, banks have a huge advantage in that the restriction does not apply to them in the context of their capacity as proxy holder for the different clients. This means that banks who hold more than 50% in proxy-holding shares will have complete control over one of the most important powers of the Supervisory Board, the election of management.

There is also no limit to the amount of share capital which a bank can hold in any one company. Although it can not invest more than 50% of its capital in any one company.¹⁷ As the banks are the most powerful financial institution, it is feasible that they could use this financial strength to take complete control of the company in a direct shareholding capacity. This rarely happens in practice.

Once the powerbase is established, banks can set about the task of appointing members of its organisation to the Supervisory Board. The maximum number is ten, and frequently, there is cross-interlocking of bank members on different company boards. The only restriction here is that a bank can not cross interlock one member of one company on a supervisory board as a member of a management board of another company.¹⁸

In his study on bank involvement in German companies,¹⁹ Brohm provides conclusive evidence of the strength of bank involvement. Of the top 100 companies, 92 had supervisory boards and banks were represented on seventy-five (81%) of them. They held more than 10% of all seats and more than 20% of all shareholder seats on the board. More than 61% of bank seats were held by the three major or "Gross" banks. The key position of the President was held by bank representatives on 20 of the 92 boards.

The data was complimented by J Bohm in "Der Einfluss der Banken auf Grossunternehmen", (1992).

¹⁷ S13(4), s 19(1), No.6 Kreditwesengesetz (Banking Act). This was modified by the EC Second Directive, and the percentage was raised to 60%.

¹⁸ Aktiengesetz 1965 para 105(1) et al. This is designed to retain the independence of the Supervisory Board.

¹⁹ Supra 15.

The incentives for the large banks to keep this degree of interest in the structure of the company are mutually beneficial for both the company and the banks. For the banks, the representation on the supervisory board means that they become privy to the information over which the supervisory board monitors. This information is, however, confidential and the members of the bank that sit on the board are not at liberty to volunteer the information to the banks.²⁰

The expertise which the bankers bring to the corporation further strengthens their belief that they have a strong influence on the supervisory board and even though the board only meets three or four times a year as a whole, meetings of part of the board meet on a more informal basis to discuss current issues in the company on a regular basis.²¹

As part of the underlying co-determination philosophy of German commerce, bankers who sit on the supervisory board will not wish to upset those members of the board who represent the employees. Confrontation between the two parties produces a negative atmosphere in which to trade. As the reputation of the company is based in its ability to act informally on the basis of trust, it is important for the company to act in a manner which indicates stability.

This is a further reason why management will only be removed where there has been a criminal offence. There has to be a good reason for the removal of management if it is to be before the end of the term of the contract.²² There has been a significant amount of involuntary changes in the management of companies, but this does not denote that the supervisory board is acting effectively. Changes may be too late or even inappropriate altogether.²³

There are however significant incentives for the banks to play a key role in the control of director performance. First there is the protection of bank credit. Banks can do this by choosing

²⁰ S 404 Aktiengesetz. The maximum penalty for disclosure is one year imprisonment

²¹ Empirical studies of the constitution of the supervisory board, was undertaken by Gerum, Steinmann and Fees in *Der mitbestimmte Aufsichtsrat: Eine empirische Untersuchung* (1987)

²² S 84(3) Aktiengesetz (Stock Corporation Act)

managers who it thinks can best take care of the company's financial policies. The power to do this comes from its influence on the supervisory board, either directly or as proxy holding members for its investors.

Second, for the bank, the inclusion of the company in one of its services will mean that the company will use the bank for its other services. As most banks offer similar rates of interest, the establishment of a relationship with one of the banks is important. A company will seek to further strengthen that relationship and thus improve its chances of incurring a more flexible financial understanding with the bank.

One of the disincentives for too much bank involvement with the management is the detrimental effect this might have on the relationship between the bank and the managers. Banks will be keen not to be too domineering in their supervision of the management, as they will want the expertise of the management to furnish commercial information important for the other financial services which banks offer to its own shareholders and principals. As companies themselves, banks will also be sympathetic to the conditions, expectations and weaknesses of the company management.²⁴

This close relationship between the banks and companies has however been the source of criticism from *laissez faire* commentators who see the closeness as stifling the company from viewing other financial institutions as a source of company financing. This may mean that the company's profit margin may be compromised by the feelings of loyalty or commercial pressure of the existing bank or financial institution connected with the company.

Banks may also want dividends to be kept high for two reasons. As a shareholder, it wants a profit, but more importantly, the bank will want to ensure that the company will not become self-emancipated; i.e. to reduce its dependence on the bank by being able to expand through its own

²³ "Takeovers v Institutions in Germany", Professor Theodor Baums. "Contemporary Issues in Corporate Governance". Prentice and Holland.

²⁴ *ibid*

capital. This effect on reinvestment and development (R&D) will ultimately have a detrimental effect on the long-term policies traditionally associated with German companies.²⁵

The cultural effect of the relationship between banks and industry which stands at the centre of the structure of the German company is important in determining the objectives perceived by and expected from the company. These objectives, unlike those in the British and American corporate systems, do not have the maximisation of profit as their sole aim. Instead, the co-operative policies adopted by companies which have mutual interests in other companies create a stability which affords the directors the luxury of viewing the ambit of their work as broader than making a profit. There is, as a result, less motivation for self-help policies which will be to the detriment of the company, but are designed to entrench their position and make them less vulnerable to the consequences of a take-over bid.

As a result of this, there is less scope for the issue of corporate governance to be raised. The directors are actively checked by the owners through the representation of the bank and are less prone to those pressures which motivate British directors to use their practically autonomous position in the company to impair the effectiveness of the company's control mechanisms.²⁶

The consequences for the insolvency provisions in German law are also affected by this cultural approach to the structure of the company and the calibre of the management.²⁷

The loss of legal personality which has the effect of exposing management to damages is found in Book 1 of the German Civil Code at sections 42 and 43. It deals with the constitution of the smaller, private company (the GmbH). Under these provisions, management will become liable for loss to creditors only where it has caused a delay in instigating bankruptcy proceedings once it was known that the company was insolvent. There is no analogous provision to the wrongful

²⁵ Corporate Control in Germany : Ellen R. Schneider-Lenne. Oxford Review of Economic Policy.

²⁶ See above in Chapter Six.

²⁷ See post

trading provision ²⁸ which tries to determine an objective criteria by which the directors of the company ought to have concluded that the company could have avoided going into liquidation. The presumption in German law is that, in the absence of intention to cause damage to the creditors, the directors of a company will act in the best interests of the company. Included in this broad ambit is the interests of the creditors. As a result, the protection of the directors under the concept of limited liability is maintained.

The requirement of some purposeful wrong is further illustrated in the following section, which withdraws legal personality on the passing of an illegal resolution or on the basis of some illegal conduct on the board.²⁹

The director will also be liable in tort for any loss caused to the creditor where he has been culpable of not initiating insolvency proceedings when the company has become insolvent.³⁰ As a result of the offence the director will become personally liable.³¹

The position of the director of the larger public company (the AG) is covered by the Stock Corporation Act 1965 (*Aktiengesetz*) and the Insolvency Act (*Konkursordnung*) most recently updated in 1997. Under S 92 of the Stock Corporation Act, the board of directors must call an extraordinary meeting of the shareholders in the event of losses in the company amounting to 50% of the company's authorised share capital. If at that point the company is insolvent, the directors must declare the company's bankruptcy immediately or within three months and can then file a petition under section 208 of the Insolvency Act. A creditor or liquidator may also file this petition.³²

For the directors, the implementation of the Insolvency Act does not automatically mean the termination of their service agreements. The administrator does, however, have the right to

²⁸ Section 214 Insolvency Act 1986, see ante.

²⁹ German Civil Code. Ref incomplete

³⁰ S 64 of the Companies Act (GmbHG).

³¹ S 823 par 2 BGB

terminate and such termination is automatically viewed as showing good cause for the director's dismissal. Under the Stock Corporation Act, the director can stay on in the company to deal with the liquidation.

These provisions, while offering the courts a choice as to the control the directors will have over the company once it is in liquidation, nevertheless, have a clearly defined timetable of how long the director has in order to do something about a company which is financial difficulty. In addition, the provisions lay down the consequences of non-compliance, the most important of which is the loss of limited liability.

The emphasis within the insolvency rules and procedures is on the speedy liquidation and distribution of assets and not on the punishment of directors. Nevertheless, problems have arisen in the German insolvency provisions relating to costs which often out-weigh the assets because the latter cannot be used as part of the liquidation. The use of the Romalpa type clause, for instance, often puts many would-be ordinary creditors into a privileged position, by keeping title to the goods until they are paid for in full allowing them instant access to the goods if payment for them is defaulted.

Reforms have taken place in Germany, in the form of the Referentenentwurf of 1989 and the Regierungsentwurf of 1991. Principles which have followed from these rules have been creditor orientated. They give the creditor wide powers in any decision which will keep the company as a going concern. The power struggle for supremacy in these provisions is illustrated by the criticisms that have come from both management and employees about the extent of the creditors new powers.³²

THE ROLE OF INSOLVENCY LAW

³² Germany : Hans Schimmelpfennig. "Directors Duties and Responsibilities in the EEC."
Compiled by Jane Whittaker and Alex Roney.

For Germany, the use of insolvency provisions to exact standards from directors, is an important aspect to the balanced perspective which insolvency law has to achieve between the creditors and the debtors.

Firstly, the ambit of management liability in the AG, is outlined at section 93(1) Aktiengesetz (AG Act). It provides that the management are under a duty to act to the level of a “well-organised and conscientious manager” in providing the supervisory board with information on *inter alia*, future business policy, the profitability of the company, the performance of the business, and the general situation of the company and its business, in so far as such could be of substantial importance.³⁴

Any breach of this duty renders the director liable to the company for damages, but not to the individual shareholder. Thus if the company’s insolvency is not detected at the earliest possible point, subject to the corporate structure and to the legal duty of care, the director will face personal liability. This is an incentive for the director to keep the Supervisory board informed to the best of his ability.

The comparative provision for the private company, the GmbH, is governed by s 43(1) of the “Gesetz betreffend die Gesellschaften mit beschränkter Haftung” (GmbH Act). These provisions require that the standard exercised by the director in the performance of his duties is that of a “well organised businessman”. This contrasts with the provision in section 214(4) Insolvency Act 1986 which defines the legal standard of care and skill as that of the “reasonably diligent person”, thus not making reference to a business person at all.

Shareholders also have a greater ability to make an input into the control of the management composition than their British counterparts. A minority of over 25% may veto the dismissal of a member of the supervisory board of the management board. In contrast, in the UK, any dealings

³³ Harry Rajak : Insolvency law. Theory & Practice (1991).

³⁴ Kurt G Weil, DROSTE Rechtsanwälte and Graham J C Vincent, Solicitor, Brussels. European Corporate Insolvency.

with the composition of the manager, including a dismissal must have 50% of the shareholder's approval which has to be sought at a general meeting. A minority of 10% can call for the dismissal of a supervisory board member. Thus the composition of the board which chooses the management can be more easily influenced by smaller groups of shareholders. Coupled with the fact that concentration of share ownership in Germany is greater than that in the UK, this has the effect of being an effective device for management monitoring.³⁵

Further liability for the corporate officers arises where there has been loss to the company when the company is insolvent but as yet, liquidation proceedings have not taken place. The situations are as follows: the officers were late in applying for the commencement of compulsory liquidation proceedings or the commencement of judicial arrangement proceedings ("Konkursverschleppung"); the officers undertook contractual performances which reduced the size of the company's assets; the officers entered new obligations. Breaches of the AG or GmbH Acts may result in civil or even criminal sanctions.

For the officer in the AG, the time limit in which an application for liquidation must be made is "without culpable delay" or, at the latest, three weeks from the events which justify the prohibition of making any such payments. The supervisory board must oversee that the directors are observing their statutory duties. If this is not the case, members of the supervisory board are liable to pay damages.³⁶

The same three week maximum is imposed on the management of the GmbH.³⁷ Both the company itself and the creditors can claim damages from making the directors liable.³⁸ The director is further liable to compensate for payments made for the company after confirmation of the company's over-indebtedness and where the payments are not compatible with the duty of a proper businessman.³⁹ The underlying philosophy of the provisions is that the creditor is

³⁵ See ante

³⁶ Sections 116 and 93(2) AG Act

³⁷ Section 64(1) GmbH Act.

³⁸ *ibid*

³⁹ Section 64(2)

protected.⁴⁰ German legislation is much less ambiguous than the factual consequence of the British legislation.⁴¹

The German insolvency system is however in the process of reform. A new Insolvency Act planned for 1997/8. The process of German insolvency law is that like British law is constantly seeking to ensure that the company is kept going where possible, while trying to combat any abuses which a too pro debtor law may engender. One advantage of German insolvency law is that it is not subject to the greater pressure of having to act as a statutory measure which will produce an objective paradigm for corporate activity.⁴²

With the advent of two separate acts to create a general legal standard for the different directors in both private and public companies, the German system has gone some way to recognising some of the necessary alterations which will be required in the law. The legal definition of a director is to correspond with the expectations of the broader nexus of groups which the director serves in the corporation and beyond.

THE FRENCH POSITION

The French philosophy underlying the issue of corporate governance, is rooted in the centralist commitment to the protection of society. As Baker & Brown illustrated in their report on the French system of corporate governance (1977), the French Government "... is intimately involved

⁴⁰ See ante 24

⁴¹ See ante Chapter 2

⁴² See ante Chapter 4, in particular *Re D'Jan of London* (1994) 1 BCLC 561

in business organisation and governance. It participates significantly in economic endeavour ... and in 'societe d'economie mixte'.⁴³

The influence of the state may be illustrated by examining several central controlling institutions which underpin the commitment of the French system to central control of corporate management. These include :

- i) Centrale des bilans. This is a central database contributed voluntarily to by 40% of France's biggest companies. The information contains an overview of the company's performance including the balance sheet and a director's report on the company's annual performance. The information is open to public scrutiny at a cost of about £1000.
- ii) Centrale des Risque. This contains information about the company's lending and is a good indicator of the company's indebtedness. The information is compromised by the fact that only French banks contribute to the data.
- iii) Fichier bancaire des entreprise. Where companies have a turnover of over 5FF million , their position concerning repayments is scrutinised to see if they have fallen into arrears. This provides further information for the potential business client as to the credibility of the company's trading position.

The effect of these influences in the French system of corporate governance is to create a management elite in the form of highly powerful ruling families who contribute to the system by controlling the voting shares in the company. In addition it creates a management structure which sways most favourably to the advantage of the chief executives and the directors.⁴⁴

The French equivalent of the public limited company is the Societe Anonyme. The company is able to choose the structure of corporate governance it wishes to adapt. For example, they may

⁴³ Baker & Brown, taken from "Keeping Good Company", Johnathan Charkham, 1994

adopt a traditional board of directors (whose Chairman is also the general manager) or a two tier system which is very much like the German model introduced for the first time in 1966.

The traditional model displays the centralist attitude to the system of corporate governance as it emphasises the power of the company's chief executive: the "président directeur-général (PDG)." The main thrust of the PDG's power is that he can choose the management board. The strength of his relationship with the board depends very much on the character of the PDG but the day to day management of the company will be strongly influenced by the PDG's ability to construct the constitution of the board.

The PDG is the head of the Conseil d'Administration (the board) who in turn re-elects the PDG. Obvious political decisions as to the construction of the board will mean that the PDG will sometimes be able to entrench his position. However, like Great Britain, France has witnessed increasing shareholder activism in the past decade, particularly through the medium of financial and investment institutions. Apart from these formal representations with actual board power, shareholders can also be represented by censors who petition the board with policy decisions which take into account the interests of the shareholder.

The increase in shareholder activity has made the board more shareholder sensitive, but in the traditional form, the French company does not have the formal supervisory role of a second board containing a representation of all the constituent parts of the company. Such a company structure is now available to French companies by the introduction of a new company structure initiated in 1966. The structure emulates the German system in that a supervisory board determines membership of the management board. This board is known as the 'Conseil de Surveillance'. The board over which it sees is known as the 'Directoire.'⁴⁵

⁴⁴ Company Law in Europe : Fommel & Thompson, 1975

⁴⁵ Supra 1.

This newer system of corporate structure has not proved popular in France and its adoption by companies is the exception.⁴⁶ There are certain situations, however, where the system has been implemented (including post-mergers) to represent a turning point in the company's life and as a means of dividing power among two or more governing families. The system can also be used at a particular point in the company's history followed by a return to the original system once that situation has passed. For instance, the transition from a partnership to a SA to ensure that the procedure does not produce an unfavourable result for one of the parties involved.⁴⁷

The incorporation of this new corporate structure into the French system allows for flexibility when companies from Germany and Japan decide to establish subsidiaries or new ventures in France. The two tier system allows them to feel "at home" and provides a degree of continuity from the principal company.

The disadvantage of the new system is that while shareholder activity has grown in France providing a degree of policing over the directors, the majority of shares constituting the major companies are state owned. The centralist philosophy of the state has been more disposed to the traditional system of corporate structure.

Criticisms voiced over the new system of corporate structure have included the lax approach adopted by the 'board de surveillance' and the continuation of the centralised power of the PDG.

The French system could be viewed as a system which understands the advantages of both German/Japanese and UK/USA approaches to the corporation. The choice afforded to French companies after 1966 illustrates that both systems have certain elements which can offer advantages to the effective running of the board. However, the reluctance to accept the new system, by the vast majority of French companies shows how imperative the cultural background

⁴⁶ By September 1990, only 7.6% of companies had adopted this new system, and the use of the new system has been in decline since then. These figures were reproduced by CREDA (the Paris Chamber of Commerce.)

⁴⁷ Prentice & Holland. *Contemporary Issues in Corporate Governance*. 1993.

of corporate governance to any response from the government or society to the issue of director policing remains in France.⁴⁸

The new system actually affords the directors more security by ensuring that any decision to dismiss them is not the product of PDG's politics, but is instead a product of a consensus vote which it is hoped will provide a more justified course of action for mismanagement.

In the traditional system the PDG still maintains his power in many areas of the corporation. In particular, his relationship with the worker's representatives who are in the 'Comite d'Enterprise.' Here, the PDG is ostensibly committed to disclosing company policy to the Comite at board meetings as the Comite has a right to sit on the board, but not to vote. The PDG will, however, circumvent many of the board meetings to ensure that the Comite is not privy to certain aspects of company policy.

It is this predilection for centralised power which has made banks reticent to interfere with the traditional system of corporate power. Despite the fact that the German system with its close relationship between banks and companies is viewed with respect, the banks have no wish to undermine the position of the PDG by making him subject to bank scrutiny.

The caution employed by French corporations to implementing the German system is indicative of the same desire for cultural independence which lies at the heart of the inability of the European Community to actually harmonise the corporate structure.

⁴⁸ Current Status of Council Directives concerning Corporations in France and Analysis of Proposals for a Fifth and Thirteenth Directive (1993), Stephane J Cournot, International

INSOLVENCY AND THE LIABILITY OF THE FRENCH DIRECTOR

Like its British counter part, the French director is made liable for debts of the corporation which result from the corporation becoming insolvent (or bankrupt as the French position states). The initiating act which rendered the director personally liable was the Bankruptcy Act of 1985.

First, the provisions of the act apply to both *de jure* and *de facto* directors, which is equivalent to the broad provisions laid down in the Insolvency Act relating to civil wrongs being practised by directors.⁴⁹

Under the French system, a director will be made personally liable for the debts of the corporation if there has been a transaction prior to the bankruptcy which has involved mismanagement, and which as a result has diminished the assets available for distribution to the creditors. The directors' only defence is that they acted properly and with due diligence and took all necessary measures in the circumstances.

In Article 180 of the Act, where there is evidence that any negligent mismanagement (*faute de gestion*) that contributed to the state of insolvency, the court may order all or part of the corporation's debt to be paid by those acting as directors (*directeurs de fait*). Liability is joint and severable. The exposure to liability for the director is therefore considerable.

The provision emulates to some extent the "wrongful trading" provision outlined in section 214 Insolvency Act 1986 in that it attempts to establish an objective standard for directors' care and skill. For British directors, however, one of the problems with that section is that there need be no mismanagement for the section to be used, and the factual events which will render a director liable are not exhaustive.⁵⁰

Business Lawyer, p195

⁴⁹ See in particular sections 212-218 of the Insolvency Act, discussed in Chapters 2, 3 and 4.

Here is where the French legislation is more informative. Under Article 182 of the Bankruptcy Act 1985, a list of events is given in which a court may render bankruptcy proceedings against a director. These include :

- i) Alienating corporate assets as if they were the director's personal property;
- ii) Using the corporate veil to dissemble actions intended for the director's personal benefit;
- iii) Using the company's assets or credit in a manner inconsistent with the company's interest or for the personal benefit of the director or any other person or company in whom the director has a direct or indirect interest;
- iv) Abusively maintaining for personal benefit a policy that could only lead the company to insolvency;
- v) Keeping false accounting records destroying accounting records or failing to maintain proper accounting records in accordance with accepted accounting practices, and
- vi) Misappropriating all or part of the company assets or fraudulently increasing the company's liabilities.⁵¹

Clearly, these provisions contain some degree of misappropriation of the corporate assets by the director and arguably are more restrictive than the open ended provision of wrongful trading with its albeit criticised agenda of acting as a deterrent to corporate mismanagement. The French provisions on management liability for insolvent corporations are more in keeping with the

⁵⁰ See above at Chapters 3 and 4.

⁵¹ See "International Liability of Corporate Directors" edited by Dennis Campbell and Christian Campbell. Lloyds of London Press. 1993.

general rules in European countries which concentrate on negligence and wilful appropriation of assets or the manipulation of the insolvency process.

THE PROPOSED EEC FIFTH DIRECTIVE ON COMPANY LAW IN EUROPE: THE VREDELING DIRECTIVE AND THE PROPOSAL FOR A SINGLE EUROPEAN CORPORATE FORM

The influence of European Community law over the Companies Acts of 1985 and 1989 indicate the indomitable position of the European Community in the development of corporate law in the UK. All legislation on company law which ranges from changes to the *ultra vires* doctrine to the composition of group accounts for group enterprises have a basis in European Community directives and the influence of the Community carries with it an agenda based on a number of different principles reflecting the Community's own policy on company law.

One of those principles is the growth in the corporate group in the European Community. The effect of the growth of the post war international based corporations is that the laws of the different countries which are home to the one institution fail to provide a coherent system of policing those directors whose influence will stretch beyond the host nation. This is a product of a socio-economic shift in the last twenty years which has seen a dramatic rise in the concept of the group enterprise.⁵²

The net result of this shift has been a decentralising of share ownership in the corporation as the share base has diversified to take into account the large number of smaller share owners in the market as well as the major institutional share owners. The power vacuum that results is filled with an increasingly autonomous directorial system of management which itself has dramatic implications for the questions of governance.

⁵² "Corporate Groups In Europe: Governance, Industrial Organization, and Efficiency in a Post-Modern World." David Sugarman, Lancaster. From "Regulating Corporate Groups In Europe" Editors Sugarman and Teuber. Baden-Baden 1990.

The emphasis of the corporation in the European Community reflects the growing socio-economic trends which are a product of western social development in the past thirty years. The period is known as “post Fordism” or “neo-corporatism”. The major characteristics of this scenario, is the breakdown of the classical industrial social structure based on class polarity, mass production and homogenous labour markets which represented the major class struggles of the particular society. The result is a more decentralised and specialised labour force which demands a more pluralist approach to management and especially to the control of directors.⁵³

The momentum for change in the legal structures which formulate the modern corporation have been enhanced by the changes in the social and political structures in the wider context. In particular, the decline in the polarity in the relationship between management and the labour force has initiated an atmosphere in which a more circumspect and consensual approach can be adapted on the issues surrounding corporate control and governance.⁵⁴

Thus there are two major branches from which the corporate structure will continue to grow. This represents the changes and aspirations of the different groups in the modern corporate nexus. First, there is the change to the traditional concept of the corporation.⁵⁵ This reflects the changing nature of the corporate form as being representative of the equilibrium which is to be struck if the corporation is to remain in touch with those natural persons who make up its component parts. In this respect, any development in the infrastructure of corporations would illustrate those contemporary principles in society towards profit, labour, creditors and the concept of ownership.

As Gordon states:

‘[In] practice it is just about impossible to describe any set of basic practices without describing the legal relations among the people involved- legal relations that don’t simply condition how people relate to each other but to an important extent define the constitutive terms of the relationship, relations such as lord and peasant, master and slave, employer and employee, rate payer and utility and tax payer and municipality...The law governing social relations - even when never

⁵³ See inter alia, Berman (1982), Sabel (1982), Jameson (1982) and Hyman and Streeck (1984).

⁵⁴ Ante at 26

⁵⁵ See ante, inter alia Berle and Means.

*invoked, alluded to, or even consciously much thought about ... has been such a key element in the constitution of productive relations that it is difficult to see the value ... of trying to describe those relations apart from law."*⁵⁶

Second, appreciating that as the corporation begins to cross more and more national boundaries, those changing concepts of the corporation cannot be evolved on a piecemeal basis, isolated in national laws, but for commercial consistency and efficiency, requires an international harmonisation process.

The emphasis for change carries with it therefore, the phenomena of group enterprises and inter corporate relations. In this respect, British law has been partially adaptive in modern day legal reasoning. The concept of corporate groups has had recognition as an exception to the rule of separate legal entity where the holding corporation is claiming damages for compulsory purchase from local government.⁵⁷ This rule is now established as an important part of corporate life.

However, the polarity in the relationship between those in the corporate nexus is reflected in the way that laws governing the corporation fit awkwardly into the needs of the other groups. Thus company lawyers will concentrate on the position of the shareholder and management, while labour lawyers will look at the position of the employee and competition lawyers at restrictive practices. It is in challenging this citadel that the objective of the harmonisation process in the European Community has been concerned.⁵⁸

In achieving this objective, European Community law has to break with those traditions which have stood as a vanguard hallmark of modern corporate law, the most central of which is the concept of limited liability. There is a need to waive this concept to allow parent companies to be liable for their subsidiaries; the proposed Ninth Directive echoes this concept albeit in certain circumstances.

⁵⁶ Robert Gordon (1984) "Critical Legal Histories". 36 *Stamford Law Review* 57

⁵⁷ *DHN Food Distributors v Tower Hamlets London Borough Council* [1976] 1 *WLR* 852, [1976] 3 *ALL ER* 462 (Court of Appeal)

⁵⁸ *Supra* 31

The issue of shareholder responsibility is also thematic in the creation of a new European corporation as the subject of their duties arises. This is particularly true in the areas of dominant shareholders, as their position has already been curtailed in English law by the doctrine that they must act in the best interests of the company, and that they do not have an unfettered discretion to act simply by virtue of their majority holding.⁵⁹

In the USA, the fact that the dominant shareholder owes a higher duty than the ordinary shareholder has been codified in the American Law Institute's Principles of Corporate Governance: Analysis and Recommendations. The duty is more akin to the duties held by the directors and reflect the idea that the shareholders cannot waste corporate assets in order to fulfil a particular objective of their own (Part V Chapter 3 s 5.10).

The expansion of those groups which have a legal right to a duty stemming from the corporation and those that manage it is part of the revolution in corporate law, since the early 1920's. European Community law has already illustrated that it will be prepared to recognise the position of the creditor as being owed a duty by the company even before the company becomes insolvent.⁶⁰ The position of the creditor has been given greater significance in English law with the passing of the Insolvency Act 1986 and related legislation concerning the area of wrongful trading.⁶¹

However, the proposal to elevate the position of the employee in the corporate structure has been met with both adversity and inconsistency in the European Union.⁶² This aspect of future corporate structuring is highlighted in several proposals from the Community. The use of Directives can be seen as only one of a number of ways in which the diverse needs of the corporate form in Europe can best be served.

⁵⁹ See inter alia *Clemens v Clemens Ltd* [1976]2 All ER 268

⁶⁰ See inter alia *Brady v Brady* (1987) 3 BCC 535.

⁶¹ See ante Chapters 1-3

⁶² See Post

In this respect, any attempt to establish a common corporate structure which incorporates many of the duties which have been bestowed upon different groups in the company will have to compromise the freedoms and flexibility which have been afforded to corporations, post World War II, to define their own internal structure. It is not impossible for one such structure to be prescribed,⁶³ The European dilemma is one which highlights the political and economic problems faced in creating a common corporate structure.

The position of the European Community is illustrated in three directives relating to the subject of corporate structuring, and displays some of the problems with defining the concept of harmonising in European Community law.

Article 54(3)(g) of the Treaty of Rome lays down the duty of the Council and Commission of the European Community in harmonising the law relating to companies within the community. It states that this will be done:

"...by co-ordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 58 with a view to making such safeguards equivalent throughout the community."

The objective of the different directives which have been issued on company law have attempted *inter alia* to make uniform the structure of the company model throughout the Community. One of these is the proposed Fifth Directive on company law.

The draft Fifth Directive⁶⁴ proposal by the Commission to the Council, is based on Article 57 of the Treaty of Rome which requires the Council consults with the Economic and Social Committee and the Assembly prior to passing judgement on it. The draft Directive was issued on September 27th 1972, and an opinion was first rendered by the Economic and Social Committee on April 22 1974, with a probability that the European Parliament (legal committee) would review the proposed Directive.

⁶³ Haaden. "Inside Corporate Groups " 12 International Journal of the Sociology of Law" 271.

Twenty five years later, this proposed Directive has still not been agreed by the different Member States of the community. The circumstances which have led to this paralysis in the evolutionary process of harmonising company law in The European Community will now be analysed. The problems of implementing a paradigm hypothesis and its effects on corporate structure in the UK will also be evaluated.

The proposals advocated by the Commission contain two important elements based on the German model of corporate governance; the two-tier board structure and the policy of allowing workers participation on company boards over a certain size.⁶⁵

Under Chapter II of the initial draft, the management board is to be appointed by the supervisory board⁶⁶ which in turn is to be appointed by the general meeting. No less than one third of the members of the supervisory board shall be appointed by the workers as their representatives.

The initial reaction of the Section for Industry, Commerce, Crafts and Services of the Economic and Social Committee of the European Community (the "Section") was delivered on the fifth draft on April 22nd 1974. It supported the idea that there was a need for company law to be harmonised within the Community and, in particular, harmony in the corporate structure. This it was hoped would provide for transitional co-operation and easier attainment of the industrial policy objectives of the Community.

However, the "Section" also went on to argue that the imposition of a full or partial two tier board structure analogous to the German model on all the Member States was 'premature'. The section recommended that a choice be given to Member States. They should be able to choose between

⁶⁴ COM (72) 887 Final, Brussels, September 27, 1972.

⁶⁵ See ante on the German system of corporate governance.

⁶⁶ Article 3 of the original draft

the traditional system of corporate structuring, illustrated in the British unitary board system, and the dual board system. This has been the position in France since 1966.⁶⁷

The commentary of the "Section" seems to illustrate a move from the objective of the Commission which seems to have been to legislate towards a more integral interpretation of Article 54(3)(g), which is to make the "safe-guards equivalent throughout the Community".⁶⁸ Here, those safeguards would be conferred upon the shareholder and creditor against the growing power of the board of directors. This would necessitate certain changes within national legislation, but it has been advocated by, *inter alia*, M Chaban-Delmas, who was Prime Minister of France at the time of the initiation of the draft Directive, that the concept of workers participation could be included on a board of directors where the company had no such supervisory board, thus undermining the need for a dual board system.⁶⁹

The first version of the draft Directive offered only two options for corporate re-structuring based on the German system or the Dutch model. The difference with this second model is that the supervisory board itself, and not the workers, choose the membership of the supervisory board. The workers are given the option of vetoing the decision of the board, but there is no direct election between the workers and the board.

The arguments for maintaining the status quo in the Netherlands underlines the presumptive fears of, amongst others, managers and the business community in general. It is felt that to allow the workers, or for that matter the shareholder, to determine the constitution of the board would be to reduce the arguments of the boardroom discussion into a narrow based dialogue representing the interests of the two groups. The Dutch system advocated that issues concerning the worker should best be dealt with in the forum of the Workers Councils.

⁶⁷ See ante for the effects of this choice on the French system.

⁶⁸ "Industrial Democracy and EEC Company Law." Thomas Conlon. "International and Comparative Law Quarterly" 1975 Vol 24.

⁶⁹ "Le Monde", May 25th, 1972 (Paris).

The Dutch model in fulfilling the criteria of the draft Directive arguably represents a broadening of the provisions which came within the scope of the draft Directive by May 1982.⁷⁰ It was clear by 1975 that some concessions had to be made in relation to the original draft and a Commission's Green Paper on participation and board structure was issued.⁷¹ This was further discussed in another document from the Commission in 1978.⁷² It was the appointment of the Dutch MEP, Aart Geurtsen, to the Legal Affairs Committee of the European Parliament, which eventually led to the adoption of the amendments to the original draft by 1982. The amended draft allowed five different systems of corporate re-structuring to come within the objective of Article 54(3)(g):

- i) a two-tier structure of management and supervisory boards with employees electing between one third and one-half of the supervisory board: the German system,
- ii) a two-tier structure of management and supervisory boards, with employee representatives having the right to veto nominations for the supervisory board where the board co-opts its own members: the Dutch system,
- iii) a unitary board of directors with employees electing between one-third and one-half of the non-executive directors; a proposal which could easily be incorporated into the present British system, but which would prompt managerial reaction,
- iv) a consultative council combined with either a two-tier board or unitary board, and
- v) collective agreements guaranteeing a measure of employee participation, with either a two-tier board or a unitary board.

These options are perhaps an indication of the mammoth gulf which exists between the attitude of the different Member States within the European Community to the question of company

⁷⁰ O.J 1982 C149/17. This was amended by O.J No. C of 9.9.1983, p.2 - 380. See Appendix 4.

⁷¹ Bulletin of the European Communities, Supplement 8/75.

⁷² Doc. III/II/78

harmonisation. The nature of the separation between the management and the supervisory boards is an example of one such division.

The revision was also a product of the adverse reaction free traders felt towards the idea that the shareholders would have their right to choose their corporate structure taken away from them. This presumes of course that the role of the shareholder is to police the company and act as a final sanctioning measure if the management do not comply with their statutory duties. With such a wide diversification of share ownership in certain public companies, this of course is practically no longer the case.⁷³

However, Dine⁷⁴ comments that the harmonisation of the law in the United Kingdom with other European countries would merely amount to bringing the law in line with company practice. This presumes that the relationship between the executive and non-executive directors is similar to that of the members of the management and supervisory boards in Germany and Holland.

In Germany, there is a complete distinction between the two boards as no one on the supervisory board is able to sit on the management board. This has been the source of much criticism from those who see such a distinction as undermining the valuable communication which can flourish easily amongst the two integrated groups in the unitary system, the executive and the non-executive director. However, practice within the German and the Dutch systems provides for the management to be invited to sit in on the supervisory boards and the relationship between the two boards can be as close as they choose.⁷⁵

Article 12 of the draft directive lists a number of activities which will necessitate the approval of the supervisory organ before they can be valid as company policy:

⁷³ "Implications for the United Kingdom of the EEC Fifth Directive" Janet Dine. *International and comparative Law Quarterly* Vol.38 p547

⁷⁴ *Ibid*

- i) the closure or transfer of the undertaking or of substantial parts thereof;
- ii) substantial curtailment or extension of the activities of the undertaking;
- iii) substantial organisational changes within the undertaking;
- iv) establishment of long term co-operation with other undertakings or the termination thereof.

These provisions have survived the most recent revision of the proposed draft⁷⁶ and contain a further provision permitting the company to extend these provisions to other aspects of the management. There is also a provision which protects the third party who deals with the management when they have acted *ultra vires*, in not obtaining the approval of the supervisory board. The protection is qualified by the third party knowing that the supervisory board's approval ought to have been sought.⁷⁷

The Directive remained silent on the question of establishing a common standard of care and skill for all European Community, thus further illustrating the difficulty of defining an appropriate level of competence for directors.

The Directive states that national legislation will determine the extent of liability of the directors and the directive's proposal that directors should be liable for 'wrongful acts' has not been detailed.⁷⁸

⁷⁵ One of the results of the Codetermination Act in Germany has been the marked reduction in the items subjected to the supervisory board's veto: see Hadden: "Employee participation-What Future for the German Model?"(1982) *Company Lawyer* 254.

⁷⁶ COM(90) 629 final-SYN 3 (OJ C7 11.1.91 p4) Proposal amended by OJ NO. C 321 12.12.1991. See Appendix 4.

⁷⁷ Article 10(4) of the proposed draft.

⁷⁸ Article 14(1) of the proposed draft.

WORKER'S PARTICIPATION: THE BRITISH PROBLEM

In spite of the cultural gulf that exists between the British and other countries in the European Community to worker's participation, the concept of introducing greater worker participation into corporate management maintained its momentum, throughout the debate over harmonisation. The themes of consultation (Article 12) as well as information (Article 11) have led to the concept being modified rather than compromised altogether.⁷⁹

One of the options proposed to the UK as an alternative to the two tier system was the concept of the "Consultative Council" which derives from the workers councils. These bodies, directly elected by the employees would be entitled to certain information which would be made accessible to the employees, and would allow a basis for consultation between the management and the workers for any policy proposals furnished by the company management.

One of the reasons why this method would find a cultural attraction in the UK is that the country has a history of collective bargaining with employee representatives and the proposal of the consultative council would merely re-define those bargaining rights and furnish them with more detailed information about the company.⁸⁰

Negative reaction to this was firstly due to the fact that consultation with the council may be subject to the discretion of the management. If consultation on the proposals initiated by the management came at a late stage, then management would be less willing to change any decision it had intended to form part of the company's policy.

⁷⁹ Supra 71.

⁸⁰ Studies on the participation of workers in the European community can be found, inter alia in "Worker Participation and Collective Bargaining in Europe (1974): produced by C.I.R para 475. This suggests that the UK is more suitable for the introduction of such a council in the management structure because it has a history of collective bargaining in the form of trades union representation.

With the idea of broadening barriers for worker participation in the form of representation, management will react to the proposals in a way which suggests that they see the new powers merely as an extension of trades unionism. Trades unionists ironically see such proposals as cutting across their power, and undermining their already compromised position within the corporate structure.⁸¹

The initiation of the proposed Directive has been seen by commentators as a skeleton which provides for the different Member States to extend and develop the provisions through the Articles of Association within each individual company. The German and Dutch systems clearly provide an ideal to which each Member State ought to strive, but the evolution of corporate structure and the economic effects of their implementation in the differing Member States means that such ideals have had to be, at least, postponed, if not compromised.⁸²

The Report of Lord Watkinson, initiated on behalf of the CBI in 1973, saw the establishment of the supervisory board as having "effective joint control (sic) over certain matters of long-term policy." These included the outline of recommendations made under Article 12 of the proposed Directive.⁸³ The report outlined several factors which it believed would only serve to undermine the benefits of the present unitary system.⁸⁴

Firstly, it proposed that the introduction of a supervisory board would merely supplant the role of the General Meetings. This was felt to restrict rather than enhance the profile of the shareholder in any management role within the company, as the imposition of the supervisory board would impair the links which existed between the shareholders and the management board. The new division was perceived as being too structured a framework for co-operation between management and owners.

⁸¹ For a more detailed examination of this problem, see post.

⁸² Jane Welch-The Fifth Draft Directive- A False Dawn?. (1983) 2 European Law Review 83.

⁸³ See ante

Secondly, the report felt that the relationship between the supervisory board and the management board would be intimidated by the imbalance afforded to the management board in terms of actual management power. While the supervisory board had the grave responsibility of choosing the management board, the management board would be responsible for the day to day running of the company. The supervisory board was felt to have too much responsibility and too little power. The conclusion of the Watkinson Report was that it should be optional for companies to choose whether or not to implement the supervisory board.⁸⁵

Instead, the report advocated the introduction of imposing certain supervisory duties on individual non-executive directors or shareholder committees. This would necessitate a clarification of duties which was not forthcoming from British law. Ironically, once again, the shareholder could lose out by having his position as the ultimate back-stop to management performance compromised by the non-executive director.⁸⁶

In the second part of his analysis of the harmonisation process, Temple Lang deals with the issue of distinguishing the role of the Supervisory Board in its capacity as representing the interests of those who do not require daily representation with the role of other representative bodies such as works councils and the trades unions. His suggestion was a division along the lines of the traditional expectations of the differing boards.⁸⁷ In this vein, employment issues would be dealt with by the trades unions and the workers councils while those aspects of monetary and company policy which affect the employees would be dealt with by the supervisory board.

The presumption made by the Watkinson Committee is the ability of the shareholder to act as an effective policing measure. The position of the shareholder in the public company for instance is somewhat compromised by his inability to actually exert any influence when his holding in the

⁸⁴ "The Responsibility of the British Public Company, Final Report of the Company Affairs Committee, Confederation of British Industry (1973) para.59 ("The Lord Watkinson Committee").

⁸⁵ For a more detailed discussion of the report see Temple-Lang J "The Fifth EEC Directive on the Harmonization of Company Law" Part 1. (1975)Common Market Law Review 155

⁸⁶ *ibid*

company is so small. Also, the ability to actually hold a general meeting will prove difficult where the numbers of shareholders involved runs into millions.⁸⁸

There are also other cultural reasons why shareholders will defer to the directors reflecting the traditional expectation of the two groups, particularly in larger public companies.⁸⁹ Central to this theme is the fact that many shareholders do submit their capital to those members of the company who they perceive as being better placed to actually deal with company policy; the directors.

A further dimension to the problem of harmonising European Community company law is found in the election procedure to the supervisory board which is beset with the same problems of an identity crisis and underlies the differing objectives of the corporation within the European Community.

The German model promotes the idea of direct election by the employees, while the Dutch model prefers members of the supervisory board to be nominated by members of the trades union. The result of both methods may be a fusion of the two groups. Even a mixture of both processes will result in the fusion being perceived by the differing groups in the company as a compromise on their traditional relationship with each other. Superimposing this fact onto the British system, which already has an entrenched scepticism for the trades union, would make the supervisory board even less attractive as a means of corporate policing.

It is submitted that one way around the problem of the identity crisis, would be to enrol the trades union into the system which directly elects the members of the supervisory board. This would then give former union representatives the same voting position as the other employees and break

⁸⁷ "The Fifth EEC Directive on the Harmonization of Company Law" J Temple-Lang, Part 2. 1975 Common Market Law Review 345

⁸⁸ See Chapter 5

⁸⁹ For further reading see Fischel "The Corporate Governance Movement : Vanderbilt Law Review 1982."

away from the structural tradition that workers representation within the company is always through the auspices of the trades union.⁹⁰

A further move to detach the supervisory board from the clutches of the trades union is to make the elected members delegates as opposed to representatives. This would put less pressure on those who have been elected to the board to extol the rights of the workers. This would be more acceptable to the managers since trades union would not be seen as thrusting the candidate onto the board.⁹¹

Thus, Article 11(4) of the proposed Fifth Directive states:

*"The supervisory organ or one-third of the members thereof, shall be entitled to obtain from the management organ all information and relevant documents and to undertake all such investigations as may be necessary. The supervisory organ may authorise one or more of its members or one or more experts to exercise these powers."*⁹²

This means that any information which the supervisory board member obtained would be information for the benefit of the employees and not the trades union of which he is representative.

Finally, the calibre of the candidate would be an all important ingredient to the success of the policing capabilities of the board. The candidate would be presumed to have a basic knowledge of company law and an understanding of the financial regulations relating to the company.⁹³

⁹⁰ It could be argued that even without the formal use of the TUs, the employees would be influenced by those who have traditionally taken a more pro-active role in employee/management relations; the TUs.

⁹¹ *supra* 65.

⁹² The article has been amended by section 7 of the amended draft of the fifth directive, 1991 (COM(90) 629 final-SYN 3(OJ C7 11.1.91). The revised article makes it clear that the information which can be obtained by the supervisory organ, is "necessary to the exercise of its supervision" making it clear that the ambit of the boards power to demand information is limited.

⁹³ For further evidence of the need for training within the corporation, and the wishes of the directors to comply with on-going training, see *ante* Chapter 6.

The proposed Fifth Directive introduces personal liability for the management of the company as part of its plan to exact a higher standard of duty from the director. This liability will come from breaches of:

- i) the law;
- ii) the memorandum or articles of association;
- iii) duties which render their acts wrongful.

The provisions will not apply if the director can show that he was not at fault. However liability is both joint and severable and thus the ambit of the liability is as broad as the provision in the Insolvency Act relating to wrongful trading.⁹⁴

Like the wrongful trading provision, there seems to be some ambiguity over the actual definition of 'wrongful acts.' Submissions for a definition include 'acts contrary to the principle of equality between shareholders' and 'misuse of discretionary power', as well 'as breach of duty'.⁹⁵

These submissions suggest that a director will be liable for negligent acts which are the result of a failure to comply with his fiduciary duties to the shareholder.

THE PROPOSED VREDLING DIRECTIVE

Like the proposed Fifth Directive, the proposed Vredling Directive also envisaged a degree of participation by employees in the management of the corporation, and was the second submission

⁹⁴ See ante Chapters 2 & 3

⁹⁵ Supra 63.

from the Commission to the Council in 1983 for such employee inclusion.⁹⁶ The initial second proposal was produced in 1980, but subsequently amended in 1983.⁹⁷

The proposal was controversial as it established the requirement for workers participation in the management structure of the corporation. Unlike the proposed Fifth Directive, however, this proposal envisaged only an indirect input from employees. This is far less radical than the direct involvement in the Supervisory Board advocated by the Proposed Directive.⁹⁸

Although less radical than the proposed Fifth Directive, this proposal has engendered much controversy in the European Community.⁹⁹ On the one hand, the European Industry Organisation, UNICE, as well as business organisations from outside the Community, in particular the USA, insist that the draft “Vredling” Directive, even as amended in accordance with the views of the European Parliament in 1983, is “neither necessary nor useful”. They argue that the proposals are covered by the International Labour Organisation guidelines. In contrast the European Trade Union Confederation emphasises its merits as safeguarding the employees interests.¹⁰⁰

The Proposed Directive was amended in 1983 and raised the controversial topic of group relations and employee participation. Under the amended proposal of 1983, the Directive was to apply to groups of undertakings (parent undertaking and subsidiaries) which employ in total at least 1,000 workers within the Community as a whole. It also applies to single undertakings operating through geographically distinct branches and employing in total 1,000 workers in the Community (Article 2). Clearly, this qualification seeks to ensure that the larger corporations fall within the scope of the directive.

⁹⁶ The first submission was in 1970, OJCE 1970 C 129 as amended. The directive was named after the Dutch member for the Commission who was responsible for social affairs during 1980

⁹⁷ The initial proposal OJCE 1980 C 297. Amended Proposal OJ 1983 C 217. See Appendix 4.

⁹⁸ See ante. The proposal was named after the Dutch member for the Commission who was responsible for social affairs in 1980.

⁹⁹ See inter alia, Peter Lawrence -ed.; “Vredling: No, No, No!” CBI News; 9th March 1984 at page 1.

The main objective of the proposed Directive is to ensure that employees are “informed and consulted” by the corporation’s management in any policy decisions taken on behalf of the company. The procedures enacted in 1983 to facilitate this objective have proved complicated. Under the Irish Presidency of the Council in 1984, a “new approach” was proposed to solve some of the administrative complexities of the Directive.¹⁰¹

Another problem addressed by the Council discussion paper was the definition of the term ‘group undertaking’ to which the provisions of the Directive apply. In determining this definition, the legal exercise of control is the traditional approach, but a *de facto* control may also be adopted. There was a presumption that the two are interchangeable,¹⁰² but this raises further problems when the question of weighted voting rights are used by a corporation in some, but not all areas of the corporation.

The amended proposal of 1983 requires the management of a parent undertaking to forward general information, giving a clear picture of the activities of the parent undertaking and its subsidiaries, to the management of the subsidiaries in the Community. The Directive specifies both type of general and specific information to be supplied; this includes details of the economic and financial situation, the employment situation and probable trends, and investment prospects.

Clearly, parallels can be found between this directive and the Draft European Company Statute of 1975, the OECD Guidelines and both German and Dutch law.¹⁰³ For example, where any failure to disclose occurs, employee representatives could petition the management for the information “without delay”. The revised text did respect the authority of the local management by taking out the provision which allowed parent management to supply directly to employees of the subsidiaries any information which they requested.

¹⁰⁰ Jorn Pipkorn “Employee Participation and Public Regulation in Corporate Groups in the EC. 1992.

¹⁰¹ A discussion paper is published in *European Industrial Relations Review* 133, February 1985, p10 et seq. The Presidency of the European Union rotates every six months. This is detailed in Article 146 EC.

¹⁰² See Article Three of the proposed Directive - Appendix

¹⁰³ See ante.

The consultation requirements laid down in the proposed Directive include any decision which “concerned the whole or a major part of the parent undertaking or of a subsidiary in the Community, which is liable to have serious consequences for the interests of the employees of its subsidiaries in the Community.” Also, “precise information” must be forwarded “in good time” before the final decision is taken with a view to being passed onto employee representatives.

The term “serious consequences” may include those situations which will radically alter the position of the employee, such as the closure of establishments, substantial modifications of the undertaking’s activities or major modifications affecting the undertaking’s internal organisation, working practices and production methods. Specifically, reference is made to the introduction of new working technologies.

The employees representatives must be allowed 30 days to consult on the proposal before it is implemented. The opinion must be received before the proposal is implemented. This opinion however, is free to be disregarded by the management.

The draft falls short of giving the employees those co-determination rights which are a conspicuous part of German governance. Furthermore the proposed Directive gives no jurisdiction for discussing the social consequences of the management policy, thus falling short of the proposed Directive for a European Company Statute.¹⁰⁴ This restraint is characteristic of modern labour law and is illustrated in the Collective Redundancies Directive and the Acquired Rights Directive,¹⁰⁵ to which the proposed Directive was to form a complimentary role.

¹⁰⁴ See Post.

¹⁰⁵ Council Directive 17th February 1975 on the approximation of the laws of the member states relating to the Safeguarding of Employees Rights in the event of Transfers of Undertakings, businesses or parts of businesses (77/187/EEC) OJ 1977, No. L 61/27. Also Council Directive of 14th February 1975 on the approximation of the laws of the Member States Relating to Collective Redundancies (75/129/EEC) OJ 1975, No. L48/29. This Directive was amended by Council Directive of 24th June 1992 (92/56/EEC) OJ 1992, No. L245/3.

One further controversial aspect of the proposed Directive was the issue of confidential information which may prove harmful to the corporation if it were to be made public to anyone outside the immediate management. The balancing act which has to be struck between the interests of the employees and the interests of the company were achieved by the company being allowed to keep secret those policy decisions which were important to the development of the company and which needed to be kept a secret. Nevertheless, the abuse of this process by management may render the proposals ineffective. As a result the Commission proposed that the employee representatives have a right to appeal to an independent tribunal in an administrative authority in order to determine whether or not the information should be kept secret.

The final controversial aspect of the proposed Directive was the procedure laid down for the election of the employee representatives. The Commission did not follow the opinion of the European Parliament and adopt direct elections as laid down in the proposed Fifth Directive. It opted for the more flexible approach leaving the election procedure to be decided by the individual Member State. In particular, Article 5 of the proposed Directive states that where a Works Council already exists, then this body shall receive that information outlined in Article 3 instead of the employee representatives. Moreover, a single works council may be established from an agreement between the management and the employees to represent all of the employees in the parent/subsidiary group.

The importance of this aspect of the proposed Vredeling Directive is that it acts as a formative base for the subsequent Directive on the Establishment of European Works Councils for those companies based in Europe, but not based in the UK.¹⁰⁶

¹⁰⁶ See *inter alia* Directive on the Establishment of European Works Councils: Effect on UK and Non EU Companies. Frank Woodbridge and Rose D'Sa. Business Law Review Vol 5 No.11 November 1994 p295.

THE AMENDED PROPOSAL FOR A EUROPEAN COMPANY STATUTE 1975

In keeping with the underlying commitment to the harmonisation of corporate law and governance within the European Community. The first proposal for a single European company law statute was initiated in 1970. It went further than the usual principles of private international law by proposing that the company becomes subject to the Statute as soon as it is controlled by a European company. This derogates from the usual position of the dependent companies' host nation from formulating the legal rules on which the company is based. Article 224 of the draft statute provides that any company conforming with the requirement of the proposed statute will be subject to a centralised management.

The draft statute included the three most controversial elements of the European debate concerning corporate restructuring and governance including :

- 1) 'The formation of a European works council representing all the employees of a European company with establishments in different Member States.'
- 2) The capacity given to a European company to conclude with the trade unions represented in its plants, uniform collective agreements throughout the EC, and
- 3) The representation of employees on the supervisory board which appoints, supervises and may dismiss the management board and which agrees on strategic business decisions. The Commission proposed that the supervisory board consist of 2/3 shareholder representatives and 1/3 employer representatives.

It was this composition which The European Parliament proposed should be radically altered four years later when a tripartite composition of the supervisory board was initiated, containing:

- i) one-third representatives of shareholders;
- ii) one-third representatives of employees;
- iii) one-third members co-opted by these two groups who are to be independent of both shareholders and employees and who represent "general interests".

The establishment of a group works council was laid down in Article 130 and employees of all enterprises in the group were to be represented (Article 131). These groups were to be given similar powers to those of the European Works Councils in matters affecting the group. (articles 134-136).

The importance of the establishment of a European Works' Council was illustrated in the amendment which extended the rights of the councils. There were two modifications in the amendments of 1975. First, the works' councils are not just confined to a consultative role on all issues relating to basic entrepreneurial decisions such as the closure of a plant, as was the case in 1970. The proposal of 1975 included consultation as to the decision itself (Article 125) and that the social consequences be subject to a social plan (Article 126 a) on which the European Works' Council has to agree.

Second, the Works Councils may ask the court to decide what information has to be kept secret by the members of the Works Council and thus the Group Works Council. Thus, it is not left to the management to decide unilaterally what information may be passed onto their workforce.

The proposals have been met with fierce debate in the Member States, particularly from those states that see the introduction of the employee council as a way of undermining the balance struck in national law regarding existing industrial relations. However, in its White Paper on the Completion of the Internal Market the Commission declared that a Statute for European Companies is required for the internal market of 1992.¹⁰⁷

¹⁰⁷ Doc. COM (85) 310 FIN. NO. 137

DIRECTIVE ON THE ESTABLISHMENT OF EUROPEAN WORKS COUNCILS

In line with the philosophical objectives of Vredeling and the structural formats for corporate internal management outlined in the proposals for a single corporate form, the Council of European Union passed a directive on the implementation of European Works Councils on 22nd September 1994.¹⁰⁸

The Directive is part of the Agreement on Social Policy, the so-called "Social Chapter", which is annexed to the Treaty on European Union, and to which the UK did not give its signature at that time.¹⁰⁹ The UK has now signed the Maastricht Treaty Social Protocol and as a result the European Works Council Directive has to be implemented within two years.¹¹⁰

The preamble to the Directive displays a deference to the increasing international perspective in the corporate arena. Clearly, the employees in one Member State were being guided by policies undertaken in another country where the corporation had its head office. In many cases, the relevant management decision may be outside the scope of the national legislation governing rights for the employee to receive such consultation, and thus employees were treated unequally in the Community.¹¹¹ With an end to the cross frontier boundaries on trade, in theory, in 1992, the position relating to this inequality has accelerated.

¹⁰⁸ Council Directive (94/95/EC, OJ 1994 L 254/64). The initial proposal for such a directive was initiated by Proposal 91/C 39/11. See Appendix 4.

¹⁰⁹ The Agreement is annexed to Protocol 14 on social policy which is annexed in particular to Article 2(2) of the treaty establishing the European Community. Social Agreement is now incorporated into the main treaty.

There has been much debate over whether the British opt out was in fact legal as a Directive has direct effect under Article 2 EC which states that the Community will have as its task the job of 'implementing the common policies or activities referred to in Article 3, which ensures that competition is not distorted in the Community. Debate has further suggested that without the UK's signature i.e. all members signature, an agreement would not be a Directive but an inter-governmental agreement. For further reading see R.Owen Glamorgan Law School 1998.

¹¹⁰ Brussels Agenda. March 1998.

¹¹¹ Supra 105

In spite of the urgency to create a structure which is common to all signatories of the Protocol, the Directive does take sufficient notice of the different practices of the Member States in their corporate traditions and management structures.¹¹² This factor alone evidences the problems of imposing one particular, prescriptive structure. The Community has already encountered such difficulties in the corporate field, in particular, the failing of the initial (and subsequent) proposed Fifth Directive and the Vredling Directive.¹¹³

The Directive thus aims to provide for the establishment either of a European Works Council or an alternative procedure for informing and consulting with employees in every "Community scale undertaking" and every "Community scale group of undertakings".

The Directive is aimed at the large sized corporation and does not wish to burden the small and medium sized corporations with legal, financial and administrative procedures which might hold the company back in its development.¹¹⁴ As a result, the Directive will apply only to those corporations with an undertaking of 1000 employees in the Community as a whole with at least 150 employees in each of two Member States.

The Directive may be avoided by those corporations which, at the time the Directive was implemented, already had an agreement for the transitional information and consultation of employees.¹¹⁵ It is only when this agreement comes to an end and is not renewed that a corporation will become subject to the provisions of the Directive.¹¹⁶

The definitions of the phrases "Community scale undertaking" and "Community scale group of undertakings" are defined in Article 2(1) of the Directive as an undertaking with at least 1,000 employees in the Community as a whole, and at least 150 employees in at least two Member

¹¹² Supra 107 preamble.

¹¹³ See ante.

¹¹⁴ Article 2 (2) of the Agreement on Social Policy.

¹¹⁵ Article 13(1). For this purpose, consultation is defined in Article 2(1) (f) of the Directive as "... exchanging of views and establishment of dialogue between employees' representatives and central management or any more appropriate level of management.

¹¹⁶ Article 13(2).

States. This proviso is very similar to the qualification for co-determination structures found in Germany.¹¹⁷

The definition of a 'group of undertakings' for the purpose of the Directive is based on that contained in Council Directive 89/440/EEC of July 18th 1989 (OJ 1989 L210). A group of undertakings is defined in Article 2(1)(b) as a controlling undertaking and its controlled undertakings. Article 3(1) defines this as an undertaking which can exercise a dominant influence over another undertaking by virtue, for example, of ownership, financial participation or the internal rules which govern it.

The Works Council could be initiated either by the central management or at least 100 employees or their representatives in at least two undertakings or establishments in at least two different Member States (initially excluding the UK, which has now joined).¹¹⁸ This means that the requirement for the commencement of the EWC can come from either management or a sufficient number of employees. Central management is also required to designate a "representative agent" to establish an EWC where the central management is not based in one country.¹¹⁹

Provision is also made for a special negotiating body to govern the structure and ambit of the initial EWC.¹²⁰ The Member State will be able to choose the election of this body, but it will be subject to the principle that each Member State which has an undertaking or has one of the qualifying group undertakings is represented.¹²¹ The bodies' wide ranging powers which it exercises in conjunction with the central management, can decide if the corporation's undertaking in the UK will be subject to the establishment of an EWC. The central management's negotiation must lead to an agreement, the contents of which are defined in Article 6(2). However, the

¹¹⁷ See ante.

¹¹⁸ Article 5 of the Directive.

¹¹⁹ Article 4 (2) of the Directive

¹²⁰ Article 5 (2) of the Directive.

¹²¹ Article 5 (2) (C) of the Directive.

corporation may decide to follow its own alternative structure and ambit which does not follow the recommendations of the Article.¹²²

The result of this flexibility is further illustrated in Article 13 of the Directive which allows valid alternatives to the EWC Directive to be implemented by the corporation where there is an agreement already in place. It may form the whole or just part of the alternative structure or may act as a base to which other companies amongst the different undertakings in one group of undertakings can have their particular alternative tailor made.¹²³

The Works Council Directive also gives a list of subsidiary requirements which will come into force should the Directive not be adopted, or an alternative not be adopted within six months from the date of the request outlined above or where after three years from the start of negotiations between the central management and the special negotiating body no agreement has been reached. This seemingly lengthy time to reach an agreement has not proven popular with Trades Unions in Europe and the establishment of an EWC could take as long as five years from the date of the Directive's initiation.¹²⁴

The structure of the subsidiary requirements regarding employee participation, include having a minimum of three and a maximum of thirty six members. The flexible and broad scope of the council's powers, illustrated in Annex Article 1(c), are akin to the powers given to the employees in the German works councils.¹²⁵

¹²² Article 6 (3) of the Directive.

¹²³ For further discussion on this point see "Like It Or Lump It - Your European Works Council, No.2" Learmond-Criqui, Houben, Stoel and Smith Vidal, *Business Law Review* March 1996.

¹²⁴ This is as a result of the two year period given to comply with the initial negotiations leading to a EWC under Article 7 of the Directive, then a three year period for the negotiations to be concluded, under Article 14.

¹²⁵ For further reference to the background and scope of these Councils, see above. In particular, Nat West has voluntarily taken on board a Staff council. It has 54 representatives for a workforce of 85 000 world wide. The document indicates that the council will deal with cross-border issues and goes on to point out that it will not deal with local issues, clearly defining the scope of the EWC. See post

A list of reasons for consultation between the central board and the employees is given in Annex Article 2 and Annex Article 3. They include : the introduction of new working practices; the employment situation and the trend; mergers; cutbacks and collective redundancies, as well as relocation; the closure of establishments and collective redundancies.

Issues that do not have to be discussed however, are found in Article 8(1) of the Directive and include information which the management deems to be confidential. This includes information which the management expressly deemed to be confidential but does not cover anything which may be impliedly confidential. The law relating to *inter alia* insider dealing would tend to show that in certain circumstances, information must be treated as confidential.¹²⁶ The presumption therefore that can be made about the ambit of confidential information is that it will not include anything which is price sensitive to the share value of the corporation.

Here of course we see a potential conflict as the onset of mergers or take-overs is one of the most pertinent ways in which share values can be affected albeit on a short term basis.¹²⁷

Finally, the expenses for the meetings of the Work Councils will be borne by the Central Management, unless otherwise agreed.¹²⁸ Undoubtedly, this expense is one of the major drawbacks in convincing the Confederation of British Industry of the merits of implementing a Works Council.¹²⁹ Meeting must take place at least once a year between the Central Management and the representatives of the Works Council.¹³⁰ The meetings themselves may not involve a great deal of people, but the expenses are broad in their ambit, and will include travelling costs, interpreters, and accommodation.¹³¹

¹²⁶ *Supra* 83.

¹²⁷ The provision is similar to that in the Directive on Insider Dealing (89/592 EC, see OJ L 334/30 18.11.89.) and displays a legitimacy in allowing directors to refuse shareholders and employees information when exercising their duties to the corporation.

¹²⁸ Annex Article 7

¹²⁹ CBI Response to the European Commission Communication on Worker Information and Consultation, 1996

¹³⁰ Annex Article 2 of the Directive.

The Directive did not affect British corporations directly, but the British corporation may find itself subject to the provisions of the Directive where it has an undertaking on the Continent which complies with the definition of a qualifying undertaking as laid down in the Directive. For the British corporation in that circumstance, there is a degree of flexibility. The corporation could implement a tailor made version of the Directive's compulsory Works Council, but this will only provide the corporation with some time to debate the inevitable outcome of having to implement some form of European Works Council. As the Social Chapter is now to be signed by the British Government, the position in the UK will reflect that already in process on the Continent.

The nature of those corporations which come within the definition of a qualifying corporation restricts the number of British corporations which will be caught by the provisions of the Directive. Nevertheless, the Directive will apply to many major multinationals. The presumption however, is that a multinational will deal in the same business in the different countries throughout The Community and does not take into account the fact that central management and employees in one undertaking will have an agenda for working practices and corporate policy which bears little or indeed no relevance on the practices in another Member State. In this circumstance, the relevance of the Works Council becomes marginalised.¹³²

VOLUNTARY IMPLEMENTATION OF THE EUROPEAN WORKS COUNCIL

DIRECTIVE

The Directive gives provision for a more flexible approach to be taken by the corporation in implementing it. Under Article 13, a corporation may already have an agreement which fulfils the

¹³¹ In 1996, United Biscuits held a two day council meeting involving 44 workers representatives at a cost of \$40,000.

¹³² See ante at 85.

requirements of the Directive. For some British corporations, this simply represents a policy toward greater employee consultation which has been enacted in such a voluntary scheme.¹³³

The NatWest Group Staff Council was formed as a recognition of the value of staff input and feedback and to ensure those particular needs of a group corporation were fulfilled. The emphasis in the Council is on the transitional issues which affect the corporation. Thus it is emphasised in the document, that the ambit of the Council is to cover only those areas of policy which affect the corporation as a transitional entity and will not cover:

"issues that relate to a single country or which are handled at a local level, like pay and reward, or terms and conditions of employment."

The normal term of office for the Council representatives is three years. It meets once a year. Provision is made for the translation of the proceedings at the meeting and the format of the Council conforms largely with that laid down in the Directive.

The Council document also attaches a questions and answers section that acts as an integral briefing document which will aid the employees' understanding of the NatWest Group Staff Council. One of the questions asks :

"Isn't this (the Council) just a way for the Group to satisfy the requirements of the European Works Councils Directive?"

The question itself suggests that something further than assimilating with the European Community over the provision of a Works Council has to be achieved before implementation of a Council is made. The response of NatWest is to emphasise the benefits to business efficacy which is an integral part of the overall communication strategy of the company. It also contends rather than waiting for the more prescriptive elements of the Directive to be implemented, the corporation has instead designed a Council structure that is tailor made to meet the particular needs of the NatWest Group.

¹³³ See *inter alia*, the provisions of the Natwest Group Staff Council, which was published in

The implementation of the Works Council by NatWest is a clear indication that the corporation sees benefits, both politically and commercially, in establishing a forum in which the different constituent parts of the corporate nexus can indulge in dialogue about the global issues effecting the corporation. This is an embarrassing contrast to the steadfast view of the Government that the Directive is a negative, and costly way of achieving greater assimilation throughout the European Union.

The reservations concerning the prescriptive structures for employee information and participation have also been raised by the CBI¹³⁴. It expresses the contradiction of many commentators on the establishment of a uniform European Company structure which would assimilate the corporation within the Community. While accepting that the blocked legislation for such a company should be removed, it states clearly that British business “does not accept that there is any basis for making this conditional upon the adoption of a global approach to information and consultation arrangements or indeed upon existing rights in this area.”¹³⁵

THE COMMUNICATION FROM THE COMMISSION ON WORKERS’ INFORMATION AND CONSULTATION

A response from the Union of Industrial and Employers Confederations of Europe, UNICE, was delivered on 17th November 1995¹³⁶ to the CBI and concerned the overall perspective of employee participation in the management structure of the corporation.

Firstly, it was concluded that the proposed Fifth Directive has little prospective impact on the debate concerning the participation of employees in the structure of corporate management. It was felt that any proposed Directive on the involvement of employees in the corporation would be on a

October 1995.

¹³⁴ See ante at 99

¹³⁵ *ibid*

¹³⁶ Ref : EN/ 05/67860 1 00.P00 (FR)

consultation basis rather than as a formal inclusion in the management structure of the corporation.¹³⁷ Indeed, the contrast between the debate which led to the Directive on European Works Councils and the debates on the proposed Fifth Directive were starkly contrasted on the point of general support within the Community.¹³⁸

UNICE sees the dissent as an illustration of the general political evolution of the Community and the Members thereafter. The fact that Britain has opted out of the "Social Chapter" of the Maastricht Treaty indicating a distancing from the other Member States, is¹³⁹ perhaps a reflection on the polarity between the different members and the controversial area of employee welfare and corporate freedom.

The next step for the European Community is to decide how to harmonise the general legal standards relating to the structure of management and the objectives of corporate law generally. Until now, both have been often piecemeal in their evolution.

UNICE's suggestion is for the establishment of a European company without delay. If the European company is not initiated, UNICE believes that it will be detrimental to the image of Union and to the commercial community within the Union.¹⁴⁰

The issue of a European company statute, has been placed back on the agenda by the inception of the European Works Councils which has been adopted in the UK now the Social Chapter has been signed. The Davignon Group, in making its final report, highlighted the differences that exist between the different Member States to the question of worker inclusion in management structures, and to this end, recommended that negotiations for worker involvement is best left to the individual nation on an ad hoc basis.¹⁴¹

¹³⁷ See inter alia para 4.2.4 Communication on Workers Information and Consultation

¹³⁸ Ibid at pt II pt 4.

¹³⁹ This reported to the Commission on 14th May 1997, and to the Social Affairs Commission on 12th June 1997. Its main authors are Padraig Flynn (Industrial Relations , Employment and Social Affairs) and Mario Monti (Internal Market).

¹⁴⁰ *supra* 122 at para 7.

¹⁴¹ *supra* 123 at para 3 (Annex).

As a result of this flexibility, the proposals have been met with a degree of criticism from Germany who see the lack of compulsion as not going far enough to assimilate corporate systems that are cross border within the Community. Within countries which do not have the German co-determination tradition, the proposals have been criticised on the familiar basis that it would create further costs for the corporation.¹⁴²

¹⁴² "UK holds out against model for Euro-firm" Simon Coss. *European Voice*. 29th May- 6th June 1997. Vol 3. No. 21. p4.

CHAPTER 9

THE AMERICAN AND CANADIAN PERSPECTIVE ON CORPORATE GOVERNANCE

The importance of comparing the American and Canadian systems of corporate governance with that of the British system rests in reviewing the differences in the US and Canadian corporate infrastructures, as well as the jurisdictional problems of incorporation. These problems raise many issues comparable to those in the United Kingdom and Europe.¹ The national responses to these issues however, display a diversity in the underlying attitude to corporate risk as well as shareholder expectations of the corporate managers. The result of this comparison will serve to illustrate further the capabilities and limited remit of corporate governance from an international perspective while also providing hypothesis for corporate and in particular, insolvency reform within the United Kingdom in relation to the responsibilities of corporate managers.

The underlying philosophy which relates to insolvency legislation indicates one of many differences between the legal responses to corporate law and the aspirations of the corporation and society . Since the 1986 Insolvency Act and The Company Directors Disqualification Act 1986, British insolvency law has been regarded as creditor orientated in its application and development.² The effects of the fraudulent and more importantly, wrongful trading provisions³, have led to a vigilance in the thinking of corporate managers in their relations with the creditor's own security. The emphasis of these provisions is to embrace caution in times of financial difficulty, rather than keeping the company going in the hope of being able to trade

¹ "Comparisons in UK and USA Insolvency Law." Frank and Tirous. Oxford Review of Economic Policy. Vol. 8 No.3, Autumn 1992.

² See ante Chapters 2, 3 and 4.

³ *ibid.*

out of the present financial problems. Caution is a consequence of the threat of personal liability which the directors would face as a result of a successful claim under SS.212, 213 and 214 Insolvency Act 1986.⁴

In the US a greater emphasis is placed on aiding the debtor as much as possible to ensure the continued existence of the corporation. The insolvency procedure is dealt with by Chapter 11 of the Bankruptcy Code 1978, which replaced the Chandler Act 1938.⁵ Under these provisions, the objective of keeping the company as a going concern is paramount. First the provisions allow the debtor 120 days to propose a plan to get the company out of its present difficulties and then a further 60 days to obtain creditor approval. These dates are from the date of filing for bankruptcy. They act like the moratorium found in British insolvency law, which is designed to give the managers of the company an opportunity of making a final attempt to 'turn things around' for the company and thus its creditors.⁶

This 'Cram Down' is often used to force non-assenting creditors to accept a plan by managers, who threaten the implications of the liquidator rules of complete priority which may serve to worsen the position of the creditors in the order to receive payment. Creditors can however apply for immediate liquidation, but the costs of the petition in the US, guided by the underlying objective of corporate rescue, are high, prompting the creditor to prefer the use of the voluntary arrangement or 'workouts'.⁷

These 'workouts' allow for the input of fresh capital from new sources of credit and then to give that new capital priority over the former creditors. This is very different from the British voluntary arrangement, which concerns itself with the attitude of the current position of the

⁴ See ante Chapter 3.

⁵ Supra 1. The objective of the Code is to increase the chances of the corporation continuing as a going concern. This is achieved in part by relieving the company of interest on non-secured debts and acts as a moratorium.

⁶ See S.10 Insolvency Act 1986, relating to Administration Orders. The philosophical difference between the use of such pro debtor provisions in the States and UK, is illustrated by the paucity of Aos during the 1980s and early 1990s. Figures taken from the annual report of the Insolvency Service (1986-1996) indicate that from 1993, there has been a marked increase in the use of both Administration Orders and Voluntary Arrangements.

creditors, and which will not bind existing secured debts, which will take assets by virtue of their fixed or floating charge.⁸

The choice in the US is Chapter 11 or a 'workout'. There are advantages to using the formal procedures attached to Chapter 11. First any voluntary arrangement in the form of the workout requires 100% of the creditor's vote before such an arrangement can be changed, whereas the formal procedure under Chapter 11 requires only a majority of the creditor's vote. The Chapter 11 moratorium also provides the company with a breathing space which protects the corporation from facing a 'run on assets' as creditors, secured or otherwise try to claw back their money. This does not exist in the 'workout'.

The basic presumption behind the options in US insolvency law is that it is to provide the creditor with the maximisation of company assets, but this means that the directors of the company are allowed to make every effort to keep the company afloat before it becomes expedient to wind-up the company⁹. The legislation does not contain an agenda of managerial discipline, should the company trade while technically insolvent. Within this context, the ability of the court to afford protection to the creditor's capital relies on its ability to allow priority to new capital that has been injected at the start of the 'work-out', in order to make it easier for the corporation to continue trading. This is supported by a preventative system of corporate accountability which is the major characteristic of US corporate governance.¹⁰ An essential part of this is the structure of the US corporation.

⁷ Supra 1.

⁸ Supra 1

⁹ Supra 1

¹⁰ See post

THE CORPORATE STRUCTURE IN THE UNITED STATES

It is an underlying principle in the US, that the corporation is managed by its board of directors. As the Supreme Court has indicated:

*"corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."*¹¹

As a result of this relatively liberal attitude to the structure of the corporation, minimum standards for directors are determined on a state by state basis and are thus subject to inconsistent criteria and are in fact only discussed in terms of absolute minimums, rather than creating reasonable degrees of standards for directors.¹²

Like corporations in the UK, US directors will choose an executive committee which will have ultimate decision making power, and will be constituted of a number of directors and independent or 'outside' directors.¹³

As a fiduciary, the director will have certain duties which for a long time in the US have been to the company and the shareholder.¹⁴ In carrying out his responsibilities, the director must act with a duty of loyalty and a duty of care. The director must ensure that the corporation and his interests do not conflict, and that his activities are exercised in good faith.¹⁵

¹¹ Cort v Ash (US Sup Ct.1975), 422 U.S.66

¹² "Responsibilities of Corporate Officers and Directors Under Federal Securities Laws.5th Edition", CCH Editions Ltd. 1993

¹³ These are similar to NED's in the UK in that they provide they provide the board with an objective and independent view of policy and procedure. For analysis of their effectiveness in the UK see ant Chapter 7.

¹⁴ This compares with the British position where until recently, in the case of Re Chez Nico 1991 ChD,[1992] BCLC 192, the duty of the directors was owed to the corporation and not to the individual shareholder (see Percival v Wright [1902] 2Ch 421).

THE USE OF THE SHAREHOLDER IN CORPORATE GOVERNANCE

The position of large company ownership in the USA, shares certain similarities with that of its British counter-part. The percentage of smaller contributory whose shares are held by institutional investors has risen during the 1980's to between 50% and 60% of the total value of companies listed on the stock exchange. This figure increases with larger companies.¹⁶

For any changes to be embraced however, the shareholders must fight against a cultural disposition which sees their place in the company as deferential to that of the managers. Richard Breedon, Chairman of the Securities and Exchange Commission (SEC), underlined this philosophy, commenting:

*"By every measure the board of directors is the linchpin of our system of corporate governance, and the foundation for the legitimacy of actions taken by management in the name of the shareholders. The board has the access to the information and the power to provide meaningful oversight of management performance in running the business, and it needs to use them cooperatively and firmly. This is particularly vital when a company is in a downward spiral, since the cost of waiting for a takeover or bankruptcy to make management changes will be far higher than through board action."*¹⁷

The perception of the board as the ultimate controlling body in the company, has been challenged by shareholders seeking to communicate with each other over, inter alia, the election and dismissal of directors. To be successful in any meaningful way however, the SEC must modify its regulations which are set in a philosophy of managerial supremacy.¹⁸ This

¹⁵ For an overview of the British position see Chapter 5.

¹⁶ See Carolyn Brancato, Columbia University Center for Law and Economic Studies, Institutional Investors and Capital Markets: 1991, Update 8 (1991) (institutional ownership of the total US equity market increased from 33.1 percent in 1980 to 53.3 percent in 1990).

¹⁷ Richard C Breedon, Chairman, Securities and Exchange Commission, Corporate Governance and Compensation, presented at Town Hall, Los Angeles, California (June 1992).

¹⁸ The relation of communication between shareholders is currently dealt with in : Regulations of Communications Amongst Shareholders, Exchange Act Release No. 31, 326 1992 SEC LEXIS 2470 (Oct.16, 1992).

philosophy is supported by a corporate structure which consolidates that supremacy by making the practical application of what is a broad based share ownership difficult to implement.¹⁹

The second problem for the shareholders is that of allowing the shareholder information which is price sensitive raising the problem of insider dealing.²⁰ There are the practical problems of communication between the board and shareholders and amongst the shareholders themselves. The eclectic nature of the shareholders makes it impossible to distill all the different policies into one policy representative of the shareholders as a whole.

Perhaps these factors are only the manifestations of a broader underlying attitude towards the initiation of greater shareholder intervention in corporate governance. Commenting on the passivity of the shareholder, Fischel points to the divergence in interest groups and the general attitude of deference towards the management as reasons why the shareholder would have a minimal effect on the governance of the board.²¹

Fischel then goes on to look at the types of misfeasances which the shareholder would be asked to prevent through governance. He further states that the obvious wrongs such as theft of company assets would prompt the shareholder towards some type of action against the board, but the more questionable deals of making foreign payments for contracts and not complying with the environmental laws would be done in order to advance the profits of the company. This would not necessarily prompt the shareholders to act. At the other end of the company's policy procedure, Fischel also argues that to allow the admission of shareholder ideas would always be unfair as at any one time only a small minority would be represented by the proposals.

The shareholder's ability to 'exit' the company is also seen as a further destabilising device in the objective of controlling management. The shareholder, faced with the possibility of an

¹⁹ See post.

²⁰ This is currently dealt with under the Securities Exchange Act 1934, 15 U.S.C

uphill task in re-organising corporate boards and developing new policies, may wish to change their affiliation, where the company does something of which the shareholder does not approve. The lack of commitment undermines the security of the shareholder's capacity to act as a control with a long-term perspective.²²

The position of the institutional shareholder at first sight looks more promising as a source of corporate control. In 1991, 13 of the of the largest institutional investors held 27% of the United States stock market.²³ Many of these institutions own between 2-3% of company shares, while some of the institutions own over 5% of company holdings. On this basis it is possible for 20 financial institutions to have control over a company. However despite this potential to control and openly oppose management, the institutional shareholders are reluctant to oppose director activity, and have supported management between 59% and 74% of the time.²⁴

The only break from this comparatively universal deference is the position of the institutional shareholder upon a takeover of the company. Here, the institutional shareholder has shown some assertion in the role of management but this has not extended to other areas of corporate activity.²⁵

The net result of this passivity is for the shareholder to utilise his power of exit at the expense of raising his voice in the corporate debate. This engenders an atmosphere of apathy amongst the shareholders further strengthening the position of the management. There have been

²¹ Daniel R. Fischel "The Corporate Governance Movement" 1982 *Vanderbilt Law Review*. Vol. 35 No.6.

²² See John C. Coffee : Liquidity Versus Control: The Institutional Investor as Corporate Monitor, *Columbia Law Review*, October 1991.

²³ Figures are reproduced by Professor Bernard Black, and matches institutional ownership with the Wilshire 500 Index, for the years 1990-1991.

²⁴ For a discussion on the reasons for this asymmetrical relationship, see ante Chapters 5 & 7, on the concept of "soft information".

²⁵ For instance, it is very rare for institutional investors to be involved in the re-election of directors, because the information they receive is often just a synopsis of the candidate with no real issues concerning his suitability given which may lead to the Board's recommendation from being challenged..

suggestions to combat this problem.²⁶ These have included reducing the capability of exit to raise the enthusiasm of the institutional shareholder to act. Also, delegating shareholder control to a professional group of directors who would be truly independent and be able to act as a cohesive governance model. Thirdly, to ensure that the shareholder gets the long term view of the company's position which would encourage the shareholder to stay with an unpopular company with the view of making a long term gain.²⁷

THE USE OF THE BOARD TO ADVANCE CORPORATE CONTROL

With the deficiencies in the use of shareholders as a means of controlling the managers in the company, emphasis is placed on the effectiveness of the board. This does not promote the idea that the Board will be the moral persuader of its managers, rather that the Board will act as a safety valve where the company is under-performing. In order to achieve this objective however, the Board must first comply with a criteria for structural efficiency which will remedy some of the current failings in the Board.

First, the pressure and size of most Boards means that there is little time for views to be expressed on those issues which directly and indirectly effect the company.²⁸ Where information is available for the company to furnish those views with facts, the complexity of information means a lack of cohesion in the company serving to intimidate it in speaking out for fear of publicly contradicting an existing finding in the company.

The position of the Chairman or Chief Executive Officer (CEO) inhibits the directors on the Board from speaking out against a particular company policy.²⁹ The amalgamation of these two positions means that one person determines the company's agenda and formulates policy.

²⁶ Supra 11.

²⁷ Supra 22.

²⁸ The typical board meets eight times annually. Korn/Ferry 1992, supra note 13, at 12.

As this person is the most experienced member of the Board and the most powerful, independent directors find it difficult to carry out their monitoring function efficiently and independently.³⁰

Finally the problem of the scope of director accountability is itself a cause of confusion for the company director. Traditionally, the director was concerned only to 'enhance shareholder value' but this is now viewed as too narrow³¹ and the range of people who have an expectation to receive a duty from the directors has increased, incorporating employees, customers, suppliers, creditors and the general community. These groups provide the director with the problem of balancing the interests of each nexus group, while complying with the standard of behaviour expected from each group. This can often lead to an expectation gap. In this respect, independent directors must have a clear criteria for judging director performances.³²

The objective of board control over corporate governance is perceived as forming the central nexus for good corporate management. This is in response to the improvements felt to have been achieved by the board since the sixties.³³ However, in order to make the board even more efficient, several changes were advocated to encourage openness and balance within the boardroom.

The changes advocated centered around the separation of the CEO and the chairman which would like Cadbury discourage an autocracy at the centre of the company, which could singularly influence the board. Other changes to be advocated are longer board meetings to

²⁹ In 80% of the companies in the US during 1992, the position of Chairman and the Chief Executive Officer, was held by the same person. Korn/Ferry 1992.

³⁰ "Corporate Governance: Reflections on the American Law Institute Report" Saleem Sheikh. (1995) *International Company and Commercial Law Review*. p254.

³¹ See inter alia, Ireland "Corporate Governance, Stakeholding, and the Company : Towards a Less Degenerate Capitalism ?", September 1996, NLJ, and Parkinson "Corporate Law and Responsibility", Oxford Clarendon Press, 1993.

³² For the UK's response to this see ante Chapter 7, particularly the recommendations of PRO NED.

³³ Comment from "Crisis Prevention: How To Gear Up Your Board", Walter J. Salmon, *Harvard Business Review*, 1993.

fully discuss corporate policy, and improving the data made available to the management and giving access to the corporate shareholder.³⁴

The response to the problems endured in achieving these objectives was illustrated by The American Law Institute's Principles of Corporate Governance, (PCG), which is the result of three decades of research in this area. 'The Principles of Corporate Governance: Analysis and Recommendations'³⁵ in its present form is the product of a right-wing swing in the eighties, which engendered a more liberal attitude to the regulation of corporate institutions as well as a narrower perspective of the corporation's objectives and responsibilities. It focused on shareholder's advancement in terms of profit and gain as central to the position of corporate policy. As a result, the code proffers recommendations as to good management practice and does not make its content mandatory in the form of statutory guidelines.³⁶

In spite of these initial conservative responses to the issue of corporate governance, the code contains certain sections which prompt a broader perspective from directors in exercising their duties. For instance, in the area of blocking actions for, inter alia, unsolicited tenders of the company, the board 'may have regard for the interests of groups (other than shareholders) with respect to which the corporation has legitimate concern if to do so would not significantly disfavor the long term interests of shareholders.'³⁷

Parts III and III A, deal with the corporate structure and advocates a board monitoring scheme for public companies. The central construction to this structure is a division between the day-to-day management of the company, and the company's board whose job it is to monitor and control the executives. This division is to be found in S 3.01 and S 3.02 of the code. The former provides for the management of the business to be 'conducted by or under the

³⁴ *ibid*

³⁵ Published in St. Paul, Minnesota, 1994.

³⁶ Provisions governing the composition of the board of directors, the functions and powers of audit committees and of nomination committees all began as mandatory rules in Part III, but were subsequently changed to mere recommendations. A comparison can be made with the UK's political position during the 1980s which has resulted in similar self regulatory recommendations. See ante Chapter 7.

supervision of such senior executives as are designated by the board of directors. Section 3.02 then lists the 'Functions and Powers of the Board of Directors', providing for a comprehensive checklist of 'monitoring tasks' giving the board a positive agenda to pursue.³⁷

The checklist requires the backing of a strongly independent board if it is to be effective. Section 1.34 of the Code ensures this independence by requiring public companies (PHCs) to have a majority of independent directors, when there is no overall control in the company, and three in all other PHCs. The relationship which can constitute non independence is broadly defined so that the concept of independence itself is tightly construed.

With a clearly defined and tightly structured board comes the advent of Nomination Committees, the initiation of which is found in S 3A.04 of the code. Here, a majority of independent directors will, in public companies which have no overall shareholder control, become responsible for recommending candidates for directorships and for other board committees.

These provisions are of course ostensibly similar to those found in the report of the Cadbury Committee.³⁸ However, the Cadbury Committee, while advocating the monitoring role of the board, strongly rejected the idea of a two tier monitoring system akin to the German model and which is a reasonable consequence of the provisions advocated in the code.⁴⁰

The code also advocated the use of audit committees to enhance the monitoring power of the board⁴¹, while promoting the idea of compensation committees, to monitor the remuneration of

³⁷ Section 6.02.

³⁸ CA Reilly United States: The American Law Institute's Principles of Corporate Governance. The Company Lawyer, Vol. 16, No.4, April 1994.

³⁹ See ante Chapters 5 & 7.

⁴⁰ See paras 1.8 and 4.1 of the report by Cadbury. See also ante Chapter 8, reflecting on the powers and responsibilities of the respective Management and Supervisory Boards in the German system. The US proposals do not envisage a broad input from different groups in the corporate nexus, and instead emphasises the positions of the management hierarchy, by defining within a two tier structure their respective roles.

⁴¹ Section 3.05 for large PHCs and S 3A.02 for other PHCs.

directors and senior executives.⁴² Again the Cadbury Committee dealt with these committees as forming a part of its recommendations on improved corporate structure.⁴³ However, the major difference between the two codes is the make-up of the committees; the American code uses the independent director to act as the monitor for the company while the Cadbury Committee uses the Non-Executive Director or NED to fulfill these purposes. The independence of those NEDs can not always be assured. Thus the independence of the monitor is less guaranteed in the British system than in the American code.⁴⁴ The US code provides for greater clarity on the definition of independence and dictates the actual number of independent directors required to fulfill the objectives of the code.

The American code is not without its restrictions. The definition of independent director includes senior directors from other competing companies who might take a restrictive view of directorial activity⁴⁵. Nevertheless, the attempt to withdraw from the 'in-house' atmosphere which the NEDs produce a better prospect for the monitoring of the US companies to be truly independent.⁴⁶

The code's application goes beyond that of recommending a model corporate form, but also goes on to outline the expected duty of care for the individual director. In English law, this duty has been illustrated in principles relating to acting in good faith and acting in the best interests of the company as a whole.⁴⁷ These duties relating to the skill and care of the director

⁴² Section 3A.05.

⁴³ See ante Chapter 7.

⁴⁴ The vulnerability of non-executives was outlined by PRO NED who commenting in their report 1993, stated that 67% of NED's were chosen because of their connections with management rather than their ability to act as an independent monitor. Their independence is further undermined by the fact that their remuneration will also be determined by those on the Board who are being monitored.

⁴⁵ Section 1.34.

⁴⁶ The establishment of a "Nominating Committee" (Section 3A.04) was recommended by the code but is not enforceable. The provision recognises the benefits of the German two tier system (see Chapter 8) and is a clear indication of flexibility in the US, towards different governance structures being implemented. This contrasts vividly with the Cadbury recommendations (See Chapters 5), and the UK's ambivalence to the implementation of the two-tier system.

⁴⁷ See Chapters 2, 3, 5 & 7.

are subjective and are set at a low level and objectivity has come only sporadically through insolvency and to a much lesser extent, employment legislation.⁴⁸

The position in the US outlined in the code, reflects a more sophisticated approach to the responsibilities of the director for while the overall standard of the performance is intended to be more objective than the British counter-part, the relaxation of the standard is considerable and illustrated in the business judgment rule.⁴⁹

S 4.01(a) requires directors and officers to act “in good faith in a manner which he or she reasonably believes to be in the best interests of the corporation and with the care that an ordinarily prudent person would reasonably be expected to exercise under similar circumstances.” Sections 4.02 and 4.02(a) also permits the director to make reasonable inquiry and to rely on others but only where the director reasonably believes that such is warranted.

From this strict starting point, the business judgment rule [BJR] described in S 4.01(c) introduces what commentators have described as “a judicial gloss on duty of care standards that sharply reduces exposure to liability” and offers “a safe harbor for directors and officers who make honest, informed business decisions that they rationally believe are in the best interests of their corporation”.⁵⁰

The net effect of this rule is to allow the director the freedom to make difficult commercial decisions in a time of crisis without engaging any personal liability. This justifies the active but unfortunate director whose actions were independent and well intentioned but whose policies in the commercial field end in a loss for the company. The business judgment rule in this respect helps the unfortunate Stakanovite director but will give no shelter to the passive director who does not engage at all in policies which will attempt to create a profit for the company.

⁴⁸ *ibid.*

⁴⁹ See ante Chapters 5 & 7.

⁵⁰ For further discussion on the business judgment rule see *ibid.*

One final compensatory point in the code, is found in S 7.19. Here, companies can limit the amount for damages for innocent breaches of care. The limit may not be less than the annual compensation for the director or senior executive and at first light seems to further undermine the position of the duty of care. However, ironically, the provision has encouraged a more vigilant approach by the courts to smaller claims against the company. Previously, the courts felt that the risk of allowing a floodgate of claims against directors for the smallest of breaches would impose horrendous damages for one mistake. By capping the claim from the beginning, the courts are more confident that such a scenario will no longer arise.

A further duty affirmed by the code is that of fair dealing which means that any transaction which is later ratified by the shareholder must be done so only where the shareholder, director or senior executive is disinterested (S 5.02). This precludes the shareholder from ratifying an action where the shareholder has an interest in the contract. The position in Britain focuses on article 85 of Table A which states that 'a director may vote on an issue in which he has an interest so long as he discloses that interest to the board first of all so that it may determine the wisdom of allowing him to vote.'⁵¹

The position in the UK, displays a more generous disposition to the director and shareholder who have the power to control and ratify transactions in the company.⁵² The Companies Act in focusing on shareholder approval for, *inter alia*, substantial property transactions (S 320) does not require that the shareholder be disinterested.⁵³

⁵¹ Directors are statutorily bound to disclose their interest anyway under S 317 Companies Act. The section and Article 85 illustrate a change in UK company to the idea that to have an interest in a contract automatically presumed a conflict of interest (See *Aberdeen Railway Company v Blakie Bros* (1854) 1 Macq 461). The corporation can still give the director the right to vote on such a contract (Art 94, Table A).

⁵² See *Northern Counties Securities Ltd. V Jackson & Steeple Ltd.* [1974] 1 WLR 1133, [1974] 2 All ER 625 (Chancery Division).

⁵³ However, the provision still applies where the director sits alone as the sole director/shareholder, and has to approve a transaction by himself (*Duckwari v Offerventure. Court of Appeal (Civil Division)* 7 July 1994). Failure to comply with this provision will

Nevertheless, common law dictates that the shareholder can not always choose the motivation behind why he votes in a particular way. In legislation giving the shareholder the capacity to alter the articles it is imperative that the shareholder acts in the best interests of the company, and that equity is employed to define the ambit of this principle.⁵⁴ The jurisprudence which has evolved in the area of altering the articles, displays that the judiciary are prepared to intervene in the management of the company. However, the difference between the American judiciary and the British judiciary is simply one of defining the extent of the intervention. The American judiciary is positive about its capacity to intervene in the running of the company, but traditionally the intervention of British judges has been by stealth and the idea of determining whether a transaction was fair, has been viewed by many although not all as being beyond its forensic capabilities.⁵⁵

Similarly, the code's contribution to the principles surrounding the director's ability to make a profit also displays an element of certainty which is not found in the British system. Section 5.04 declares that :

"...[a] director or senior executive may not use corporate property, material non-public information, or corporate position to secure a pecuniary benefit." However under S5.04(a)(4) such a benefit can be obtained if it is ratified by disinterested shareholders in advance .⁵⁶

result in damages being paid only if the shareholder suffers damage at the time the SPT was made.

⁵⁴ This is illustrated in the cases of *Brown v British Abrasive* [1919] 1 Ch 290, in which the buy out of recalcitrant shareholders was held not to be in the best interests of the company. The buy out was attempted through the alteration of the articles. In the case of *Shuttleworth v Cox* however, the buy out of a director there was held to be in the best interests of the company, because he was competing with the present company. Other cases such as *Clemens v Clemens* [1976] 2 All E.R. 268, and *Estamanco (Kilner House) Ltd v G.L.C* [1982] 1 All E.R. 437, display the use of equitable considerations being placed upon the ratifying powers of the majority shareholders.

⁵⁵ Supra 27.

⁵⁶ This is not the only situation where the director can benefit. For example, the director may benefit where value is given to the corporation, where the benefit amounts to compensation, where the use is of information, does not harm the corporation and does not amount to

The British approach to the situation is to be found in the 'no profit rule' which has a stringent yet inconsistent case history. The harsh decision of *Regal (Hastings) v Gulliver*⁵⁷ displays a judiciary which puts the rule relating to non-profit before any equitable considerations surrounding whether the directors were acting to the detriment of the company. Subsequent decisions such as *Island Export Finance v Umunna*⁵⁸ shows that the courts will allow directors to benefit from their past connection with a company so long as the benefit had did not result in any direct detriment to the company. The case suggests that the director can make a gain from his connection with a company but is less clear than the American code about criteria which has to be adhered to before such a gain can be taken.

The court's intervention in the British system suggests a lack of confidence displayed in the internal corporate structure; the lack of board independence to act as an effective monitoring system in particular. The effectiveness of the American code is to elevate such concerns and allow the internal structures of the corporation to take care of itself.

The role of the shareholder as a monitoring device in the company, is most frequently manifested in the use of the derivative action (DA) which is more common in the US than in the UK. The threat of the DA for the company is less in the actual resulting litigation and more in the time consuming process which follows the initiation of such an action.

In the US, the starting point for bringing such an action is generous to the shareholder as no fraud or wrongdoing is required.⁵⁹ This liberal stance has the potential for abuse had there not been stringent safeguards against the use of the process. This is put into process by the corporation through an application to the court, requesting it to dismiss the application. The court will apply a two part criteria.

insider dealing, and where the benefit is made proportionately available to all other similarly situated shareholders.

⁵⁷ [1967] 2 A.C.136.

⁵⁸ [1986] BCLC 460.

Firstly, it will look at the procedure followed by the company, to request the dismissal. This will usually have been taken by a Special Litigation Committee and will be made up of shareholders and the board. The point for the court here is to ensure that the decision was taken independently.

Secondly, the court will look at the substantive merits of the case. The test is subjective and will depend on the seriousness of the wrongdoing and the seriousness of the harm which has been caused to that part of the company seeking a dismissal. Cases which are simple to undertake are those concerning the dismissal of directors. In order to dismiss a DA by claiming this, the director simply has to show that the business judgment rule (BJR) applies.

In order to ensure that the board is objective in its decision to request a dismissal of DA, the code states that the board should be composed of 'two or more persons, no participating member of which was interested in the action and should be capable of objective judgment in the circumstances' (S 7.09(1)). Further, the board or committee 'should be assisted by counsel of its choice and such other agents as it reasonably considers necessary' (S 7.09(2)).

In looking at the requisite standards for dismissing an action, three categories become clear. First, where the underlying transaction amounted to a breach of duty. The application of the BJR here is used for both bringing an action and measuring whether it should be dismissed.⁵⁹ Second, the category involving more serious misconduct, where the underlying transaction could not itself be reviewed by the BJR. This would occur where there had been a knowing violation of the law in the execution of duty. Here the board must show that it was 'adequately informed under the circumstances' and has;

"reasonably determined that dismissal was in the best interests of the corporation."

⁵⁹ Section 7.02(c) also permits a director to bring a derivative action (provided that he is able to represent fairly and adequately, the interests of the shareholders).

⁶⁰ Importantly, this category includes compensation transactions which under S 5.03 have been authorised by the directors. The decision to authorise also has to meet the BJR.

(S 7.10(a)(2)). The third and final category of misconduct resembles something much closer to the concept of fraud in the UK. Here, the board's power to dismiss a DA are limited. If the dismissal of the DA would permit the retention of a significant, improper benefit : (i) by a defendant who is in control of the company or (ii) where such benefit was obtained, in essence, fraudulently or by self-dealing, the court shall not dismiss unless " the likely injury to the corporation from continuation of the action convincingly outweighs any adverse impact on the public interest from dismissal of the action".⁶¹

The position of the board is central to this process, and thus its independence is vital to ensuring that the decision to request a dismissal of a DA is in the best interests of the corporation. The process is also important for establishing a measured rapport between the board and the shareholder, as the former will have to justify its actions to the latter if they are to remain valid. In comparison, derivative actions in the UK, such as fraud on the minority, illustrate that a rigorous regime is in place, but do not have the safeguards found in the US code.⁶²

The important structural point to be made about the implication of the code is in its definition of the differing degrees of directorial culpability. This contrasts with the evolutionary and undisciplined doctrine of fiduciary duties in English law.⁶³ The consequences of such clear definition, are that the courts are able with greater ease to judge the merits of a case and whether they permit a particular result to follow.

For the differing contractual bodies in the company, the code gives a more integral and modern perspective on the role of the director both as corporate activist but more importantly as corporate monitor. This has been helped by having a code with a clear understanding as to its objectives. In contrast, the UK's use of insolvency law to stretch the responsibilities of the

⁶¹ Section 7.10(b).

⁶² In the case of *Smith v Croft (No2)*[1988]Ch 114, the procedure for the DA in the UK is outlined. The need for reform for the derivative action in the UK is illustrated in The Law Commission Report on Shareholder Remedies. Report No. 162, July 1996.

director, have been so torn in deciding the main thrust of its objective as to render itself emasculated in comparison.⁶⁴

HARMONISATION OF THE CORPORATE STRUCTURE

The code clearly expresses the model for the transformation of many of the US medium and larger companies, but that form is subject to the fact that firstly it is not law, and secondly, it belongs to a country which has a legal infrastructure which translates across many jurisdictions. For the US, this has meant a tradition of inconsistent approaches to differing themes within the law. The role of the federal law was not to bring into its ambit, the controversies of bad management and shareholder grievances.⁶⁵ Rather it provided the imposition of duties which helped facilitate the duties of the director like the duty to disclose and inform investors. It is only in this limited context that liability for corporate directors is focused upon in the federal law.

In order to transform the code into a coherent and consistent form of corporate governance the issue of harmonising the law in the different states has to be discussed. In this respect we shall see that similar problems in the European Community system will be found here.

Perhaps the greatest argument for advocating harmonisation in the field of corporate governance, is the creation of a consistent chain of objectives which will promote a standard form of management. To detract from this objective, is to create an area which will produce a 'race to the bottom' that is, a race, the objective of which is to find a jurisdiction with the minimum of regulation and the maximum in 'opt out' clauses relating to liability for the director.

⁶³ See ante Chapter 5.

⁶⁴ See ante Chapter 3 and 4.

As Clive Schmitthoff wrote back in 1973:

*"Unless the national company laws in the community are identical in all essential aspects, a movement of companies to the state with the laxest company law will take place in the community. If it may be said without giving offense to our friends in the USA, the community cannot tolerate a Delaware in its territory."*⁶⁶

The reference to Delaware, displays an understanding from the US, of the problems faced by having a weak state link in the federal chain. Professor Walter Kolvenbach, former President of the European Company Lawyers Association has observed:

*The goal of harmonisation of company laws of the Member States...presents continuing difficulties. Citizens of a Member State (including business associations formed under its laws) are generally able to extend their business into the territory of any other Member States. A "market" thereby arises for company laws, which offers the business the greatest degree of latitude. On the other hand, "Company Law Delawares" were to be avoided.*⁶⁷

Such reference perceives the political sensitivities raised in achieving this harmonisation from a federal state, which has to try and transcend the evolution and the differing backgrounds of the states involved in a particular union.⁶⁸

Nevertheless, the incentive to create harmonisation shows a need to combat the 'shopping' for the most liberal jurisdiction undertaken by corporate managers, as well as the need to create harmony in the growing internationalisation of corporate personality and in particular corporate finance.

The position of Delaware reflects a similar story of evolution which formed the present day underlying philosophies of Western corporate structures. The choice of Delaware as the major centre for incorporation took place during the second and third decades of this century. This was after New Jersey, through progressives like Woodrow Wilson had tightened their corporate laws. Delaware offered a pro-managerial option to those families who like the

⁶⁵ Golub v PPD Corp. (CA-8 1978), 1978 CCH, Dec. 96, 450.

⁶⁶ Clive M. Schmitthoff, "The Future of European Company Law", in *The Harmonisation of European Company Law* 3, 9 (Schmitthoff 2nd ed., 1973).

⁶⁷ *ibid.*

DuPont who drafted the code, wanted to protect their shareholdings. This has resulted today with over 40% of New York stock exchange listed companies, and over 50% of the Fortune 500 companies being incorporated in Delaware. 82% of the firms that reincorporate do so in Delaware.⁶⁹

Thus in creating a pro-managerial jurisdiction, for corporate activity, Delaware has set a starting point for jurisdictional competition in incorporation and corporate affairs. A comparison is made with the Netherlands in Europe, which has a history of liberal regulation.

⁷⁰ However, like the States, Europe has its problems of regulatory harmonisation which result in countries 'racing to the bottom' for self-motivated corporate governance.

The problem for the European community is not just one of harmonisation however, but also of doctrinal influence within inter state commercial activity. The Treaty of Rome intended to promote businesses to operate freely within the community, in a manner which was non-discriminatory. This however would be in contrast to any doctrine advocating that a company would have to adhere to the rules of the host country in which it did most of its business, regardless to the country of incorporation; the 'siege reel' doctrine.

This factor has been more recently illustrated in a number of cases which have advocated that the laws of the state of incorporation be employed to govern the affairs of the company even when the company is run through an agency in a jurisdiction outside that of the country of incorporation.⁷¹

⁶⁸ See Chapter 7 ante.

⁶⁹ Data provided by Joseph Grundfest, SEC Commissioner, to the Council of the Corporate Law Section of the Delaware State Bar Association and reprinted in Craig B Smith and Clark w Furlow, Corporate Practice Series : Guide to the Takeover Law of Delaware app.E at 162(1988). Data on reincorporation from Roberta Romano, "Law as a Product; Some Pieces of the Incorporation Puzzle", 1 JL Econ & Org. 255,244(1985).

⁷⁰ See ante Chapter 8.

⁷¹ Segers v K. Bedrijfsvereniging voor Bank en Verzekeringwezen, Groothandel en Frije Beropen, Case 79/85, [1986] ECR 2375

So what has the American tradition got to offer the European dilemma? Advocates of a decentralised regulatory system argue that a manager or director will have the freedom to choose a jurisdiction to incorporate which will offer the best return for his shareholder. This limited perspective of the role of the company, was illustrated in the case of *Amanda Acquisition Corp. v Universal Foods Corp.*⁷² Here, Judge Easterbrook explained:

“When entrepreneurs want to raise capital for a corporate venture, they must decide where to incorporate. The choice of where to incorporate in turn affects the price investors are willing to pay for shares...State that enact laws that are harmful to investors will cause entrepreneurs to invest elsewhere.”

Competition, thrives in a situation where the investor is poorly informed, as then, he will be in no position to challenge the authoritative choice of the director. For instance, it would be possible for managers to incorporate in a jurisdiction which permitted thievery, if ostensibly, the company also made an annual return on investment. Shareholder apathy makes a substantial contribution to this scenario, and engenders a feeling of autonomy amongst the directors permitting them to take a “free hand” with investor’s money.⁷³

The centralisation of regulation would therefore take away this ‘race to the bottom’ by providing uniformity for all transactions regardless of the jurisdiction of the incorporated firm. Decision makers within the company, will not have to learn a multiplicity of rules which themselves create further transaction costs either directly, through complying with any additional regulation a particular state has, or indirectly through further in-house training.

In this respect, centralisation would take away ‘rule shopping’. This phenomena is driven ostensibly by the objective of providing the shareholder with the best possible conditions for incorporation. However, the short term advantages of a high dividend may be at the long term expense of obtaining a good standard of reinvestment and development. Allowing this to happen is again a product of poor shareholder information and managerial self-interest.

⁷² 877 F 2nd 496 (7th Cir. 1989).

⁷³ See Tim Pryce-Brown: Shareholder Protection; A Cultural Quagmire. *The Company Lawyer*, Vol. 16, No.4, 1995.

If the US finds that these problems are in essence the norm for most of the corporate decision makers, then the European perspective complicates matters further with the addition of other social and market pressures which influence corporate managerial decision making. Particularly, in the German corporate environment, corporate employees, through the forum of the Supervisory Board⁷⁴, and banks, through their direct investment in the company, exert more powerful influences on managerial decision-making, than their British and American counter-parts.⁷⁵ This often provides the shareholder with sufficient incentive to be more proactive in the company's affairs, and thus the problems surrounding shareholder passivity do not arise. The directors are more closely monitored and the possibility of suboptimal reincorporation by the management less of a real threat.

Yet maintaining a decentralised set of rules for the governance of companies is well supported throughout the US. most notably from those who see the forum of a diverse set of rules as providing a consistent forum for the evolution and development of corporate rules in a particular context. This would be a product of the fact that both the US and Europe have diverse political and social evolution and that the individual countries or states take on board that particular evolution when formulating current legal rules; the so-called 'path dependency' syndrome.⁷⁶

The position of casting off this past to centralise regulation is also beset with the transitional cost afforded to those states which have to modify their regulation more acutely. This would put particular states at a disadvantage in the short term of having greater management costs than their rivals in another jurisdiction which had already in place those aspects of the model chosen for centralisation.⁷⁷ This is not only a cost for the industries involved in the transition,

⁷⁴ See Chapter 6 ante.

⁷⁵ For a history of the evolution of the German system and other corporate systems, see Alfred D. Chandler "Scale and Scope: The Dynamics of Industrial Capitalism" 506-13, 587-92, 1990.

⁷⁶ See Jon Estler, "Sour Grapes", Accountancy, 1983. P 93.

⁷⁷ See, inter alia, the debate surrounding the implementation of the German model in the EC Proposed Fifth Directive. Chapter 8 ante.

but is also a cost for those practitioners who have to learn and implement the new regulations as well as of course the courts.

There appears to be an intrinsic xenophobia to the idea of adopting a particular model if it is already the product of one of the group states,⁷⁸ but the problems beset by the different states are real. Local jurisdictions fear too strong a centralised regulation will take away the substantial advantages of maintaining the authority of creating its own legal rules.

There are though other advantages in maintaining a decentralised system of regulation. Firstly, while jurisdictional competition creates a forum for the unscrupulous director to take advantage of the most lax rules concerning corporate regulation, it also provides a forum for competition for the best rules which can then on a piecemeal basis translate the legal adoption as rules for other jurisdictions. In this vein, the locality in which the status quo is maintained may feel that it and not a centralised federation will be best placed to formulate the rules as it best placed to be aware of the idiosyncrasies of that particular locality or indeed industry⁷⁹.

Secondly, decentralisation permits changes and experiments to the corporate regulation which if it contains mistakes will have the effects limited to that particular jurisdiction. From this the errors made can be observed by other jurisdictions and the mistakes will not be repeated.

The arguments on both sides have their credibility, but the underlying remit of the centralisation theory, is based on an understanding that managers will undertake activities inside the company, for the public good, even if that is at the expense of the shareholder. For instance, laws may prohibit the use of auctions to sell shares, even though this may maximize the amount of money which the company can get for its shares.

⁷⁸ See ante Chapter 8

⁷⁹ Craypo "The Impact of Changing Corporate Strategies on Communities, Unions, and Workers in the United States of America." *Journal of Law and Society*. Volume 24, No.1 March 1997.

This presumes a broadening in the responsibilities of the traditional director. A particular example is found in the United States take-over regulation. Here, the diversity in the entrenchment tactics afforded to existing management, means that should one state be too stringent for managers resisting takeovers that are hostile, those managers will simply reincorporate in a jurisdiction which does permit the resistance tactics, even when those tactics harm shareholders as a group.⁸⁰

The use of the diversity of the take-over regulations is important as the take-over affords a pertinent motivation for the monitoring of management who wish to keep their positions safe by strengthening the company. Applying liberal rules which prevent the use of takeover, hostile or otherwise would mitigate this motivating factor and leave management lax.⁸¹

For Europe the position is even more striking as the political and cultural diversities in the system are more acute than in the American states. Thus the adoption of a centralised model for take-over regulations or controlling management will find stiff opposition from countries which have a different cosmetic make-up of corporate ownership and corporate inter relations.⁸²

The American perspective on the attempts that Europe has proposed for the effective governance of the corporation, shows both the advantages and the disadvantages of centralisation. The advantages are threefold.

First, it can co-ordinate agreement for a set of rules where uniformity facilitates transactions. This should be viewed in the context that there is a distinction between harmonisation and assimilation, but nevertheless this is a real consequence.

⁸⁰ This presumes that shareholders are of a certain ignorance, but more importantly, in the British context, that they are unable to form a strong policing element to the company, because of apathy or simply a problem in obtaining a suitable forum.

⁸¹ CF Alan Schwartz, "Search Theory and the Tender Offer Auction", 2JL Econ. & Org., 229, (1986) - (describing the impact of auctions on incentive to search).

Second, it can set minimal standards for jurisdictions, to ensure that managers do not opportunistically 'opt out' of the optimal standard by reincorporating in a jurisdiction with laxer, pro-managerial rules.

Third, it can impose rules that maximize shareholder wealth, in circumstances where these rules may be "opt out" through reincorporation. This factor is of course subject to the broadening of corporate responsibilities to beyond that of shareholder wealth creation.⁸³

For the US, the structure of corporate ownership and management power is universal. If therefore, a vested interest is viewed by keeping the status quo of decentralising corporate rules then Europe, containing a vastly diverse set of corporate structures and backgrounds will find the task almost impossible.

PROPOSALS FOR REFORM

The similarities in the structures of the British and American corporate systems and cultures, have prompted reform measures with similar objectives.⁸⁴ The first of these objectives is to create a relationship between the major fund holders and the management of the large corporations to encourage a greater interest in the holding companies from those who actually own the stock. This will erode the present phlegmatic approach taken by the holders of the major pension funds.⁸⁵

This proposal, known as the relationship investor, would involve the top one hundred corporations in the US, and the top sixty investment houses. Each corporation would have approximately eight to ten relationship investors, holding 15-20% of the companies stock

⁸² See the position of Germany and the proposed EC Fifth Directive in Chapter 8 ante.

⁸³ See ante Chapter 2.

⁸⁴ Proposals for Internationally Competitive Corporate Governance in Britain and America, Allen Sykes Professional Practice Papers, Vol. 2, No. 4, October 1994.

(slightly less for the larger corporations). Each institution would have a 'shareholder director' who because of his holding would be influential without being domineering. His role would be to monitor the senior management of the company and to ensure that it is fully accountable to the shareholders.

In order to ensure that the role of this 'shareholder manager' was exercised with a long term perspective, he would establish negotiations with the senior management for targets with a five to seven year perspective. The problem would be in finding individuals of sufficient calibre and experience to act in this role. Suggestions have included a retiring businessman with a proven track record.

The incentive for the senior managers who could work within the five to seven year program, would be to reward them handsomely, if the projected targets were exceeded. Thus the senior manager would sacrifice the short term profit regime engendered by the broad based share ownership of corporations, for a greater gain in the future.

The 'shareholder director' would be supported by a secretariat, paid for by the companies involved, which would provide the 'shareholder director' with a wide information base about the company.

The net effect of the deployment of a 'shareholder director', would be to ensure a high standard of senior staff. The experienced individual would not be prepared to have his own position in the company compromised by association with directors who were of a poor or inadequate calibre.

Connected with this would be the objective of creating a long-term perspective in the company, which would require self-discipline and greater equality in the boardroom, changing the current dominant position of the CEO/Chairman.

⁸⁵ Ante Chapter 7.

The major criticism perceived by the introduction of this system is the expectation of harmony between the 'shareholder director' and the directors. There is often conflict between the two groups. For example, the directors may want an increase in salary at the expense of an increase in shareholder dividend. So one of the objectives of the 'shareholder director', must be to balance both interests with a long-term perspective.

For the United States a slightly different approach will be undertaken. This is because unlike the British position, the US lacks the concentration of institutional investment in the major companies. (The top 30 pension funds own only 15% in aggregate of the 10 largest corporations.) As a result of such low investment percentages, the investment institutions in the US are not culturally disposed to act as corporate monitors with the responsibility of overseeing the actions of senior management.⁸⁶

Here different suggestions have been made for intervention from outside the company.⁸⁷ The institutions could operate to:

- i) Appoint independent directors to all companies
- ii) To put extra pressure on under performing companies

The problem with this proposal is that there is still the gap between ownership and control. Perhaps a better structure for the investor to adopt is the idea of an intermediary who would act similarly to the 'shareholder director' in the proposal for Great Britain.⁸⁸ Such intermediaries would look after the interests in approximately fifteen different stocks taking an active interest in corporate governance. This number would allow him the opportunity to be thorough in his

⁸⁶ Drucker P.F., "Reckoning with the Pension Fund Revolution", Harvard Business Review, March-April, 1991.

⁸⁷ Gilson, R.J. and Kraakman R, "Re: Inventing the Outside Director: An Agenda For Institutional Investors", Working Paper No. 66, August 1990, J. M. Olin Program in Law and Economics, Stanford Law School.

regulatory role while affording him the opportunity of having a broad perspective of corporate responses to governance. This structural approach was adopted in the Berkshire Hathaway company, with great success, and an unusually long-term perspective for an American company.

In order to ensure that a long-term perspective was envisaged by the intermediaries, five to seven year incentive performances would be given to the managers. The intermediaries would in practice act as a voice for the big investment institutions, although they would not belong to them. Nevertheless, they would provide a structure which would involve less passivity on behalf of the institutional shareholder.

Finally, in order to enshrine the longer term perspective of 'shareholder directors' or intermediaries it is important that their service contracts are also of a four to five year duration, subject to the usual safeguards against incompetence.

The objective of these proposals is to fulfill that power vacuum which is the product of the growing separation of ownership and control. As Barry Riley states:

*"...a power vacuum is developing that will be filled by some other economic or political interest group if the institutional investors fail to wake-up...[There is] the need to broaden the input into company boardrooms and to get the institutions off the hook of voting obligations which they can not live up to but which they are terrified of loosing to other interests."*⁸⁹

In order to take away the reliance on the inconsistent effects takeovers have on the issue of corporate governance and to restore competitiveness in the British corporation, these proposals will add a structure ready to cope with the dynamics of the modern enterprise.

THE CANADIAN PERSPECTIVE

⁸⁸ Jacobs. Michael T., "Short Term America", Harvard Business School Press, 1991.

⁸⁹ "Financial Times", February 1992.

The importance of Canada in the debate concerning effective corporate governance lies in the contrasting corporate structures which are indicative of the manager/owner relationship in Canadian companies. This contrast affords the more developing corporate markets in Eastern Europe an opportunity to look at national responses to corporate management, where the capacity and perspective of a corporation is increasingly internationalised. In doing this, a broader perspective of corporate responses to the question of governance can be assessed and the appropriate characteristics used in creating new hybrid corporate structures in those countries with little company law.

The debate on corporate governance while having endemic objectives within the international community, is subject to differing internal structures of both the corporation and the legal system in which that corporation is found.⁹⁰ Thus while Canada and the USA have similar legal and cultural origins, the response to the policing of corporate managers has been influenced by their national differences.⁹¹

So what are those underlying differences in the Canadian system which promotes such a contrasting response to the issue of corporate governance? Perhaps the most significant difference in the structure of Canadian and American corporations is the much higher concentration of share ownership found in the Canadian companies. In the 1990's, the Toronto Stock Exchange (TSE) can be broken down in the following way:

- i) Widely held corporations, that is corporations held by many, often small shareholders accounts for 15%,
- ii) Corporations held by a single or a small group of shareholders, with legal control, that is control of 50%, is 63%

⁹⁰ See ante Berle and Means, *inter alia*. Chapters 5 and 7.

⁹¹ See Ronald Daniels and Jeffrey MacIntosh, "Towards A Distinctive Canadian Corporate Law Regime.", (1991), 29 Osgoode Hall L.J.863.

- iii) Corporations held by a single or group of shareholders with effective control, that is between 20% and 49.9% accounts for the remainder 25.4%⁹²

This contrasts greatly with the position of the Fortune 500 on the American Stock Exchange, where the following figures are found :

- i) Widely held shareholder corporations - 63%
- ii) Corporations with small shareholder numbers which have legal control - 12%
- iii) Corporations with small shareholder numbers which have effective control - 18%

The most significant consequence of this structure is that Canadian corporations do not have the problem of monitoring management which is such a significant idiosyncrasy of the American and the British systems. When a particularly stubborn board decides to undermine the position of the shareholder in Canada, that board can be firmly removed at the next General Meeting. Thus there is far less need to resort to hostile takeover bids to effect management change.⁹³

The structure of corporate governance comes instead with its own idiosyncratic problems. Instead of emphasising the chasm which produces friction emanating from the relationship between the management and the shareholder, the emphasis is changed to the relationship between the shareholders and other interested groups such as creditors and employees. Notably, inflated compensation payments for shareholders, unfair self-dealing transactions, or unanticipated changes in shareholder risk taking, combine to stigmatize the tight control of the all empowered shareholder. The focus on the relationship between majority and minority

⁹² *ibid.*

⁹³ This is borne out empirically. Of 1,148 Canadian mergers in 1989, only 7 resulted in management resistance see *ibid.*

shareholder, has, as a result, prompted the advocacy of external constraints on the corporate market.⁹⁴

Exacerbating the problems connected with tight shareholder ownership, is the interconnected pattern of ownership, which has become an integral part of the Canadian corporate structure. In 1987, of the top 100 most profitable companies in Canada, 45 held 10% or more of the voting shares of another company, although few held 100% of another company.⁹⁵ This is consolidated by an extensive pattern of inter-linked directorships. In percentage terms, 71.1% of Canadian board appointments were made to directors with only one board appointment, 17.5% to directors with two appointments, and 11.4% to directors with three or more directorships. Correspondingly, the figure for the US is 81.1%, 11.1% and 7.1% respectively.

The impetus of the banks during the eighties has allowed for the conglomeration of the corporate field in Canada. An example of this is the Hees/Edper empire; during 1989 the group controlled 350 operating companies (although few had 100% control), and controlled 8.3% of companies listed on the TSE 300.⁹⁶ Further, one of the principals of the Hees/Edper group holds more (9) directorship than any other on the TSE 300.⁹⁷

The final, most significant difference on the Canadian stock exchange is the amount of stock which is thinly traded on the stock market. Only 5.35% of stock is frequently or deeply traded on the stock exchange. This indicates the infrequency, with which shares are often traded. For the governance of the company, this provides a consistent monitoring by shareholders and contrasts with the 'exit' of shareholders in American corporations, leaving because of the frustration of having no 'voice' in the company.

⁹⁴ It is notable that the preoccupation of the Canadian regulatory framework has distracted owners and policy-makers from performance orientated concerns.

⁹⁵ ante 63.

⁹⁶ See James Gillies *Boardroom Renaissance* (Toronto, McGraw-Hill Ryerson Ltd. 1992).

⁹⁷ *ibid.*

These structural differences in the Canadian corporation are only part of the broader socio-legal differences, which have contributed to the governance debate. Canada ostensibly shares similarities to the USA, in its approach to the establishment of the corporation. Both have a separate legal entity, with standards of fiduciary duties imposed upon its management. These factors are illustrated in Canadian statutes which are in fact based on American precedent.⁹⁸

Nevertheless, the differences in the Canadian legal structure have contributed to a watershed in the comparative studies of governance in the two countries. The first and perhaps the most important distinction between the two countries is the American competitive element that exists inter-state. The fact that states are responsible for the administration of corporate law prompts a vigorous joust for the market share of incorporations. In the US, this competition is led by Delaware, and has provided a controversial input into the state of American corporate freedom.⁹⁹

In sharp contrast, Canada has no such Delaware in spite of its federal legal structure.¹⁰⁰ This deprives Canada of a specialisation court, which, in Delaware has established a wealth of legal responses to evolutionary questions surrounding the role of the corporation and the responsibilities of its directors.¹⁰¹ This in turn has led to a lack of specialised commercial/corporate courts, scant judicial precedent and sluggish rates of legislative innovation.¹⁰²

⁹⁸ The similarity in the content of corporate statutes is not at all surprising given the reliance of the framers of the pre-eminent model of corporate law in Canada, The Canada Corporation Act, on American Precedents. See acknowledgment, Robert Dickinson et al., "Proposals for a New Business Corporation Law for Canada", (Ottawa Information Canada, 1971), page iv.

⁹⁹ For the impact of competition on the corporate market, see William Cary, "Federalism and Corporate Law: Reflections upon Delaware" 1974, 83 Yale Law Journal 663 and Roberta Romano, "Law as a Product: Some Pieces of the Incorporation Puzzle", 1985, J.L., Econ and Organ. 225.

¹⁰⁰ See Ronald Daniels, "Should Province Compete? The Case for a Comparative Corporate Law Market", 1991, 36 McGill L.J.

¹⁰¹ See Roberta Romana, "The Genius of American Corporate Law", (12th August 1992, draft version monograph to be published by American Enterprise Institute).

¹⁰² Ontario has gone some way to providing judges with the option of becoming specialists in the corporate/ commercial field, but this option has proven to have a minimal effect on the effectiveness of legal improvement. The decision of the trial judges who are offered this

The result has been a reliance on provincial regulators, of which the most important is the Ontario Securities Commission to stand at the epicentre of corporate law matters. For instance, the effect on the minority shareholder of any corporate activity which would have a detrimental effect on their rights, has been guarded *de facto* by the Canadian securities regulators. This has kept intervention by the courts at a low level.¹⁰³

Another important consequence of the high intervention of the local securities commission, is to prevent the management and the shareholders from asserting private dispute resolutions in the face of using an expensive and protracted court system. This can and has had a debilitating effect on the abilities of the shareholders and management to act in a way which is beneficial to the corporation. This compares to the States where such private solutions are commonplace.¹⁰⁴ The result is to foster a dependency attitude amongst shareholders and management upon a well intentioned but often undisciplined benefactor.¹⁰⁵

Regulation may have been dealt a severe blow by the decision of *Pezin v British Columbia (Securities Commission)* ¹⁰⁶. Here, the court overturned a finding of the B.C. Securities Commission into allegations of insider dealing. The court in its summing up, commented on the legislative responsibilities surrounding insider dealing and also on the more expansive obligations found in the Canadian Securities Administrators and the Vancouver Stock Exchange. It stated :

option can be overturned anyway by the Ontario Court of Appeal or the Canadian Supreme Court, and by generalist judges.

¹⁰³ On these points see respectively, Philip Anisman, "The Commission as Protector of Minority Shareholders", *Securities Law: Law Society of Upper Canada Special Lectures* (Toronto, Richard De Boo, 1989), and Edward Morgan, "Extraterritoriality and Insider Trading", paper delivered at 1992 International Bar Association Conference.

¹⁰⁴ See Roberta Romano, "The Shareholder Suit : Litigation Without Foundation?" (1991), 7 J.L Econ and Organ.

¹⁰⁵ For example, the first oppression action brought under the Ontario Business Corporations Act has languished in pre-trial proceedings for almost a decade. The Ontario Securities Commission took a lead role in the litigation; delays, in, part, are attributable to competing claims on the Commissions resources.

¹⁰⁶ (1992), 96 D.L.R.(4TH) 137, 66 B.C.L.R (2nd) 257 (C.A), leave to appeal to S.C.C granted (1993), 98 D.L.R. (4th) vii

*"Since the legislature has dealt with the disclosure issue so carefully, specifically and comprehensively, there is no room for a more exacting disclosure requirement than the legislature has imposed. To do so would be an error in law."*¹⁰⁷

This statement, contrasts with the legislative recalcitrance, which prompts the securities into acute intervention in the role of corporate governance. This produces at best an oversight of the issue, which has been described as sporadic and unpredictable.¹⁰⁸

The strength of the securities regulators within the corporate framework has also produced a passivity amongst shareholders resulting in a small number of derivative claims. This has proven to be so notwithstanding Canada's oppression remedy which was designed to prompt the Canadian courts to move away from their traditional reluctant stance to intervene in defining the fiduciary duties of majority shareholders. The scope of the remedy has been widely interpreted and is included in cases relating to public companies.¹⁰⁹ Nevertheless, the remedy is used infrequently, reflecting the continuing traditional stance of the judiciary.

THE ROLE OF THE INSTITUTIONAL SHAREHOLDER

Like the USA and the UK, Canada has seen a stark rise in the level of institutional shareholders in its widely held corporations, during the eighties; at present an estimated 50-60% of shares are held in this way,¹¹⁰ although the overall number of institutional investors is much lower. The role of the institutional shareholder has been given considerable authority from the US, where their position is augmented by the sheer size of their investment capacity and the depth

¹⁰⁷ *ibid* at p 159 D.L.R.

¹⁰⁸ Nigel Wright, "Regulatory Competition and Regulatory Culture: A Comparative Study of Securities Regulation in Ontario and the United States", LL M thesis for Harvard University.

¹⁰⁹ 820099 Ontario Inc. v. Harold E. Ballard Ltd. (1991) 49 C.P.C. (2nd) 239, 50 O.A.C. 254 (Div Ct).

¹¹⁰ "Institutions Flex Market Muscle", The Globe and Mail, November 11th 1988, pB18

of their expertise. The institutional investor has been perceived as the harmonising element in the corporate gap between ownership and control.¹¹¹

However, this perception is mitigated in the British experience, as institutional shareholders are reluctant to criticise those managers from whom they receive 'soft' information on prospective investment worth of their companies.¹¹²

The position of the institutional shareholder in Canada is still in a nascent stage, but an indication of their perceived value to the governance debate is illustrated in the strategies companies undertake to make themselves susceptible to takeover; the 'poison pill' scenario.¹¹³ The provincial securities administrators have reacted to the problem by insisting that management obtain the approval of the majority of shareholders before the 'poison pill' policy is employed.

For some companies however, this has proven difficult as some companies have diverse ownership and are unable to obtain the necessary majority. In those circumstances, companies went ahead with the policy and the attempt to prevent adoption was thwarted.¹¹⁴

The role of the institutional shareholder in the formula for corporate governance, has been described as lackluster¹¹⁵ and this can inter alia be blamed on the lack of confidential voting and the widespread vote-bundling by companies.¹¹⁶ However, the persistence of the

¹¹¹ Jayne Barnard, "Institutional Investors and the New Corporate Governance", 1991, 69 N.C.L. Rev 435

¹¹² See ante Chapter 5 & 7.

¹¹³ See Jeffrey MacIntosh, "The Poison Pill: A Noxious Nostrum for Canadian Shareholders", 1989, 15 C.B.L.J 276.

¹¹⁴ For example, see Allenvest, where the policy was undertaken as less than 50% of shareholders voted against it.

¹¹⁵ "Recent Trends in Canadian Corporate Governance." Ronald J Daniels and Edward J Waitzer [1994], Canadian Business Law Journal, [Vol. 23], page 23.

¹¹⁶ For example, the vote on the company Inco's poison pill was tied to a receipt of a one time generous dividend payment.

institutions has meant that in some cases it has become routine for shareholder approval to be sort before a poison pill policy to be undertaken.¹¹⁷

The intervention of the institutional shareholders, is still closely attached to the issue in which the company is involved. For instance, the 'voice' of the shareholders is more prominent in areas where there is a conflict of interest matter between the company and any controlling company. These issues are often undertaken through the 'low key' forum of, *inter alia*, the securities commissions and require little more than approval or dissent by the shareholders. In contrast, mismanagement problems, the core of shareholder activism in the United States, do not prompt a large response from the institutional shareholders.¹¹⁸

The concern for the institutional shareholder's 'voice', is that it is without co-ordination. In this respect it reacts often without an underlying policy towards the problems in front of it. The lack of co-ordination produces a lack of depth and quality which, if improved, would effect a more respected response from management and shareholders.¹¹⁹

The antipathy exhibited towards co-ordination is the product of a range of factors. Organisational constraints derive from the concentration of share ownership. The traditional, low yield safer investment is an anathema for corporate governance. There is also the political constraint. Any attack by public pension funds will be viewed as a veiled attack by the Government on Corporate Canada.

¹¹⁷ See Catherine McCall, "An Acceptable Poison Pill? TransAlta's New Shareholder Approval Plan", [November 1992], Corporate Governance, Revision 6.

¹¹⁸ In the States however, the position is still considered to be costly and complex. Nevertheless, recently, the American Council of Institutions declared that the focus of their 1993 campaign of inspecting the corporations would be to look for "Performance, performance, performance." See IRRC Corporate Governance Newsletter, September, 1992.

¹¹⁹ Edward J Waitzer, Are Institutional Shareholders Really Impacting Corporate Governance?", [1991], Cdn. Inv Revision 9.

The use of the public pension fund holders to act as corporate governance monitors is illustrated in the USA, where political self-interest becomes apparent.¹²⁰ Here, the monitors, while not being the poodles of those that they govern, do not aspire to align themselves with the interests of the beneficial shareholders either, keeping their own independent agenda. The result is a new set of agency problems.¹²¹ The political objectives to the governance debate, was illustrated in Canada more recently when the state of Ontario strongly rejected the idea of intrusive scrutiny in public pension funds.¹²²

The inclusion of the institutional investor in the role of corporate governance, is indicative of the benefits which the institutional investor can offer the management team.¹²³ The experience in the US suggests that this relationship will evolve without the need for regulatory intervention¹²⁴.

The second method characteristic of Canada's attempt to improve the performance of the management is to increase the level of personal liability for the board, initiated both by statute and by the judiciary. There are at present over 100 statutes in Canada, which result in personal liability for the director¹²⁵.

The proliferation of legislation is indicative of the broadening of the expectation of the directors' duties from the stakeholder. However, legislative attempts are beset with difficulties related to the challenge to the traditional expectation of the shareholder which is, that he is the

¹²⁰ See Roberta Romano in "The Future of Hostile Takeovers; Legislation and Public Opinion", 1988, U.Cin.L., Revision 457 at 469, note 32.

¹²¹ See Robert Clark "Four Stages of Capitalism; Reflection on Investment Management Treaties", 1981, 94 Harvard Law Review, 561.

¹²² See the 'Caisse de depot et de placement du Quebec'. (December 5th 1988) No. 500-05-013354-889.

¹²³ See ante Chapter 7.

¹²⁴ John Pound, "Westinghouse Lights Boardroom Path", The Wall Street Journal, December 11th, 1992.

¹²⁵ D. Palmateer (with the assistance of Grace Kimucho and Anna Torma), "Statutory Liabilities and Offenses of Directors and Officers in Ontario", draft dated October 9th, 1990.

sole benefactor of the management's efforts in the corporation. This is now being challenged by other stakeholders who see the traditional view as too narrow¹²⁶.

The problem of broadening the ambit of the director's responsibility, is in creating a vague concept of stakeholder which detracts from the director's own perspective of his duties, and thus serving to undermine them. Perhaps the best way forward is to establish the shareholder as the management's major concern but to make this subject to other stakeholder interests in the process.

A problem connected to this is the fact that too draconian a scheme of liability for the director will indirectly affect the shareholder by reducing the value of his shares and the profit margin of his corporation.¹²⁷ Implicit in this is the idea that risk involving a technical breach of duty will be tolerated in the name of expedient business practice.

Like the USA and the UK, Canada's response to the issue of corporate governance is moulded by both an increase in the level of institutional shareholders and the broadening sensitivity of the public to the evolving expectations demanded from the Board. The problem for management is that within the nexus groupings of the company, these two factors can result in conflict. The institutional shareholder, has initiated a greater demand for the management to channel their duties into the shareholder, while the other corporate stakeholders take a disadvantaged perspective from any strategic policies designed to advocate shareholder prosperity.¹²⁸

¹²⁶ See ante, Chapter 5 and Ronald Daniels, "Takeovers and Stakeholders: Contractarianism and Compassion" (1993), 43 U.T.L.J.

¹²⁷ See, *inter alia*, Henry Hansmann and Reinier Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts", 1991, 100 Yale L.J. 1879.

¹²⁸ See Ronald Daniels and Edward Morgan in "Independent Directors Should Stay Gatekeepers", The Financial Post, July 1 1992, page 10; and "Directors Face Grab Bag of Liabilities", The Financial Post, August 12 1992, page 10.

The result of this conflict may provoke a destabilising effect on corporate management who see an early retreat from the corporation a more attractive proposition than a mounting bill for personal liability.¹²⁹

This illustrates a general problem for any governmental attempt to try and bridge the gap which persists between shareholders and other corporate stakeholders. The public wants perhaps too much from its directors: an impeccable level of behaviour but also the best profit margin. If the balance between these two objectives is moved in favour of one or the other, then Canada, through those responding to the Cadbury Report in the UK, will be faced with a charge of strangling commerce for the sake of the ill-informed.¹³⁰

For Canada, the response to the issue of corporate governance is best contextualised internationally. Canada can be best described as an intermediate country in the spectra of commercial and financial markets.¹³¹ In this respect, Canada has an active stock exchange but the structural ownership of corporations is tight and thus not so susceptible to the arguments advocated which led to the Cadbury Report.¹³² Nevertheless, in advocating the need for a better system of governance which balances the objectives of both the shareholders and the other stakeholders, Canada offers a blended approach towards corporate governance deferential to the needs of the investor both per se and as a focus for broadening managerial responsibility to the corporation as a whole.

THE ETHICAL QUESTION OF THE POISON PILL

¹²⁹ In Canada during the latter part of the eighties, directors from troubled corporations such as Westar Mining Ltd. and Canadian Airlines International Ltd. resigned rather than face personal liability.

¹³⁰ See ante Chapter 7.

¹³¹ See Coffee: "Liquidity Versus Control: The Institutional Investor As Corporate Monitor.", October 1991, Columbia Law Review, Vol. 91, No. 6.

¹³² See ante Chapter 5.

The question of poison pills in both the US and Canadian jurisdictions, illustrates some of the most fundamental problems in balancing the different responsibilities involved in the running of corporations and the role of management in particular.

The pill was initiated as a defence tactic in the United States in December 1982, by Martin Lipton¹³³. In the following six years, over 800 pill plans were adopted in the US in various forms and without the approval of shareholders.¹³⁴ They were subsequently introduced into the Canadian financial markets in 1988 in the *Inco Case*.¹³⁵

The pill works by attaching certain rights to acquire shares to a sale of existing shares. These rights are traded with ordinary shares but the strike price is so high that they become unmarketable. However a certain event which attaches to the right will trigger its activation forcing the acquiror to purchase more shares in the corporation with a view to, *inter alia*, block a takeover of the corporation. In *Moran v Household International Inc.*¹³⁶, a pill was triggered upon the acquisition of 20% or more of the corporation's common shares or upon a take-over of 30% of the corporation's common shares.

The pill activates by separating the right to purchase new shares from the existing shares, and thus flood the corporation with shares. This device can then be used either to block the takeover, or at least to force the person taking over the corporation to negotiate a higher price for the existing shares by threatening the flood of new shares.

The use of the pill has been attractive to those boards of directors who wish to defend the corporation from a hostile takeover. The coercive tactic of raising the bidding price for the target corporation was illustrated in the case of Federated Department Stores whose pill forced Campeau to pay US C\$73.50 per share up from the original offer of C\$47.00.

¹³³ The pill was apparently conceived in connection with El Paso's defence against a hostile bid from Burlington and Northern Railway.

¹³⁴ See "The Poison Pill; A Noxious Nostrum For Canadian Shareholders.", 1989, Canadian Business Law Journal, Jeffrey G. MacIntosh.

¹³⁵ See post .

There are several criticisms to be made of allowing the tactic of the poison pill. First, by preventing the threat of takeover it is argued that the share value of the corporation will suffer.¹³⁷ This is based on the presumption that with the threat of the management being overturned taken away, the management of the corporation will have no incentive to achieve the optimum goals of the corporation. In a study undertaken at the end of their eighties however, corporations with pills out performed those without by 9.6%.¹³⁸

Moreover, research undertaken to illustrate the price change in shares which were brought about by the initiation of a pill produced a fall of 1% in share prices when it was announced that the pill was being adopted.¹³⁹ Studies undertaken by the Securities and Exchange Commission also show a drop in the price of shares, but less significantly at 0.5%.¹⁴⁰

Second, and perhaps more cogently, is the principle of issuing shares for a proper purpose. The principle, central to the issuing of new shares in the UK¹⁴¹, finds its Commonwealth starting point in the case of *Howard Smith Ltd v Ampol Petroleum Ltd*.¹⁴² Here directors who favoured a takeover offer from Smith issued shares to block a takeover from Ampol and associates. The court in ruling that this share issue not to be within the definition of proper purpose, confirmed the existing rule that even though the directors had not acted selfishly, the sole purpose of the issue was to dilute the majority share holding to allow the other shareholders the opportunity of selling their shares more advantageously.

¹³⁶ 500 A.2d 1346 (Del Sup Ct., 1985).

¹³⁷ See ante at 106.

¹³⁸ Study undertaken by Gergeson & Co.Inc., October 31, 1988.

¹³⁹ The study was carried out over a two day period in order to eliminate other price varying factors. Seventy three companies without other factors were observed.

¹⁴⁰ Securities and Exchange Commission, Office of the Chief Economist, "The Effect of Poison Pills on the Wealth of Target Shareholders, October 23, 1986, SEC Study.

¹⁴¹ See inter alia *Hogg v Cramphorn* [1967], Ch 254.

¹⁴² Following the above decision in [1974], All ER 1126 (P.C.)

However, in the case of *Teck Corporation v Millar* ¹⁴³ the more liberal court in Delaware ruled that directors were not in breach of their fiduciary duty to the corporation if they acted in good faith in what they believed, on reasonable grounds, to be in the best interests of the corporation. In the context of the pill the courts will have to grapple with following observations of the judges in the *Howard Smith* and *Teck* case.

In *Howard Smith*, Lord Wilberforce observed the following in relation to directors powers to issue shares:

"... to use their fiduciary power solely for the purpose of shifting the power to decide to whom and at what price shares are to be sold cannot be related to any purpose for which the power over the share capital was conferred on them." ¹⁴⁴

However, Mr. Justice Berger in *Teck* sums up the directors' duties in a specific takeover contest as follows:

"... directors are entitled to consider the reputation, experience and policies of anyone seeking to take over the company. If they decide, on reasonable grounds, a take over will cause substantial damage to the company's interests, they are entitled to use their powers to protect the company." ¹⁴⁵

A further case which offers a test for establishing the validity of inter alia a pill, is *Re Olympia & York Enterprises Ltd. and Hiram Walker Resources Ltd. (Canada)*, ¹⁴⁶ where the actions of the corporation defending the takeover were supported by the court, who stated that such a defence strategy could be implemented where it was:

- i) in good faith that they perceived a threat to the corporation
- ii) they acted after proper investigation, and

¹⁴³ (1972), 33 D.L.R. (3rd) 288, [1973] 2 W.W.R. 385 (B.C.S.C.).

¹⁴⁴ Supra 141 at 1136.

¹⁴⁵ Supra 143 at 317 and 415-416 respectively.

¹⁴⁶ (1986), 37 D.L.R. (4th) at p.194, 59 O.R. (2d) at p.225 (H.C.J.), aff'd 37 D.L.R. (4th) 193, 59 O.R. (2d) 254 (Div. Ct)

- iii) the means adopted to oppose the take-over were reasonable to the threat posed.

Clearly, these cases reflect the taxing task of the court's wish to provide the management of the corporation with the means of exercising its job with as much efficiency as possible but also to ensure that the power it exercises does not obtain an autonomy which is unhealthy for the corporation and which provides for a phlegmatic approach to the question of management motivation.

Apart from these common law arguments over the validity of the pill, Canadian law also offers statutory laws which may be activated in the context of an executed pill. In an action brought by Caisse de Depot Attack on the Inco Rights Plan, the following statutory violations were contended against the application of the Pill:

- i) the plan constituted a restriction on the ownership and issue of common shares in violation of subsection 49(9) of the Canada Business Corporation Act [CBCA];
- ii) the plan constitutes an undue restriction on the absolute right of a shareholder to transfer his shares by delegating to the directors the mandate to negotiate their sales price, in violation of subsection 49 (9) and S 102 CBCA;
- iii) the object and effect of the plan are to create a disparity of rights between holders of shares of the same class in that a shareholder holding 20% or more of voting shares of Inco is the only one prevented from exercising his rights contrary to the terms and spirit of S 24 CBCA;
- v) the plan also gives directors to decide the price at which shares would be conferred on members who held 20% of the votes; a power not conferred by S 102 CBCA, without the shareholders approval, and;

- vi) the plan contravenes the principle that securities of a corporation are negotiable instruments as provided for in subsection 48 (3) of the CBCA.

Finally and perhaps most importantly is the oppression remedy under S 241 of the CBCA, which provides for a 'complainant' which includes a director to apply for relief against the corporation where the corporation's affairs have been conducted in a manner which is 'oppressive or unfairly prejudicial'.

This section provides the court with wide discretion to grant relief which may include setting aside or varying a transaction or contract to which the corporation is a party. (Section 247 of the Ontario Business Corporation Act (OBCA)). This type of remedy is not available in the US which has no corresponding oppression remedy but for Canada, the remedy is available in two areas where the pill is in place:

- i) That the pill discourages bidders, and is thus oppressive for that reason. The issuer may argue that if properly used a pill can in fact benefit shareholders by raising the price of the shares and by defending hostile takeovers. It would seem expedient therefore to allow pills that had the backing of the shareholder's approval.

- ii) that in allowing the purchase of the acquirer's shares at 50% once he had purchased 20% of the target company (the "flip in") then the purchaser could initiate the oppression remedy on the basis that he had suffered punitive dilution if it proceeds to and beyond the specified percentage. In reply, the issuer would point out the salutary effects of the pill and the decisions of *inter alia*, the US & UK courts dealing with its operation.¹⁴⁷

¹⁴⁷ In the case of *R V Board of Trade ex p St. Martin Preserving Company Ltd.* [1964] 2 All ER 561, Astwood CJ made it clear that a "poison pill" was a legitimate defence mechanism which could be used by the directors so long as there was no collateral purpose other than to prevent a hostile takeover, or that the issue did not favour one shareholder at the expense of another, (p565).

The discriminatory elements of the pill can be indirectly evaluated by the decision of *Bowater Canada and R.L. Crain Inc.*¹⁴⁸ Here a “step-down” attempt to alter the voting power of shares if they went outside the family unit of a corporation from 10 votes per share to 1 vote per share was set aside on the basis that the corporation could not discriminate between different groups of shareholders. The trial judge (whose decision was upheld on appeal) stated :¹⁴⁹

“this interpretation is founded on the principle that votes attach to the shares as opposed to the shareholder. I agree with Bowater’s counsel that present corporate law cannot tolerate the result that the rights of a share depend on the identity of a shareholder.”

The problem for Canadian corporations is that corporate rights are contractually based and thus are capable of being varied by the participating parties to the contract. Corporations as a result may do indirectly what they cannot do directly, but employing a device which is discriminatory, such as the pill, may lead Canadian courts to strike down certain rights plans.¹⁵⁰

American cases have also engendered a defensive attitude to the rights issues arising from the implementation of a pill. In *The Bank of New York Co. Inc. v Irving Bank Corp.*¹⁵¹ the discriminatory feature of a rights plan, violated a provision of the New York Business Corporation Law which provides that subject to permissible variations in the certificate of incorporation, “each share shall be equal to every other share in the same class.” This decision is at variance with the decisions undertaken by the Delaware courts.

The “pill” issue raises questions fundamental to the role of directors and their relationship with the corporation and the different contractual groups in the corporate nexus. First, the power of the directors to act in the best interests of the corporation can be mooted over whether the use

¹⁴⁸ *Bowater Canada Ltd. R.L.Crain Inc.* (1987), 26 O.A.C.348 (Ont.C.A.), affg *McRae J.*, unreported judgment, S.C.O. January 23 1987; and see also *Jacobsen v United Canso Oil & Gas Ltd.* (1980) 113 D.L.R.(3d) 427, [1980] 6 W.W.R. 38 (Alta Q.B.)

¹⁴⁹ *ibid* at p7 of the judgment.

¹⁵⁰ In ruling that attaching rights to share, or indeed burdens, based on the identity of the shareholder was intolerable. *Mc Rae J* effectively outlawed the use of the pill which attached to shares because of the identity of one party owning a particular percentage of shares

of the pill should act as an integral part of the director's weaponry. The proper purpose doctrine, central to the themes of capital maintenance and shareholder protection, is put into question in the light of the positive consequences of share issue manipulation undertaken by the directors.

Observing this issue, the question arises as to whether there is any connection between the amount of managerial ownership in the corporation and the use of pills. In a study undertaken by Malatesta¹⁵² 83.6% of firms announcing poison pills were found to have lower than average management ownership. The difference was significant; 9.39% of management ownership with pills compared with 23.1% for the average corporation.

The suggestion here is that not only are pills more concerned with the entrenchment of the management rather than the benefit of shareholders but also that the entrenchment objective directly effects the position of the shareholders, to their detriment.¹⁵³

Second, the inconsistency of the courts response to the question of the pill illustrates the problem of the corporate personality converting to new jurisdictions in order to obtain the most liberal set of laws in its favour; the "race to the bottom"¹⁵⁴. The pressures of the directors to fend off the advances of a hostile takeover may well prompt a justification of the manipulation of the federal system to seek out friendlier states with the result that directors will be treated more liberally on a whole range of issues unconnected with the rights issue.

Third, the pill raises important questions concerning the expectation of shareholders for the directors to act in accordance with their wishes. The deference of shareholders, whilst giving the directors a sense of autonomy in the corporate structure mitigates the general legal presumption that shareholder approval is important to the decision making process of many of

¹⁵¹ 528 N.Y.S.2d 482 (N.Y.Sup Ct., 1988), *affd* without opinion, 533 N.Y.S. (2d) 412 (October 4, 1988)

¹⁵² Paul Malatesta and Ralph A. Walking, "Poison Pill Securities; Stockbroker Wealth , Profitability and Ownership Structure", 1988, 20 J Fin Econ 347 ("Malatesta Study").

¹⁵³ See *ante* at 105.

the corporation's policies. To make shareholder approval a central part of the validation process for pills¹⁵⁵ the question of information to and suitability of the shareholders becomes a further moot point.

SHAREHOLDERS IN THE CAPACITY OF PENSION FUND HOLDERS

For Canada as for other advanced commercial nations, the use of the pension fund has increased in its input into the financial base of the corporation but unlike shareholders in Britain, Canadian shareholders have been more successful in their pursuit of greater activism in the corporation's management. This may be attributed to the more closely held share ownership in Canadian corporations, which makes a shareholder input more accessible, or it could be attributed to a change of attitude from the pension fund holders to the corporation; seeking a step away from the "soft information" bias which affects the British pension fund holder from acting as an effective police force to the shareholders they represent.¹⁵⁶

In Canada, the Pension Investment Association of Canada, the (PIAC), issued a code of best practice similar to that issued by Cadbury. Although the code is voluntary, it is the basis for rating corporations in their compliance with the eighteen point code.

The significance of the code is several fold, but importantly, it asserts the asset of having the proxy machinery which represents billions of dollars of pension fund monies. Secondly, it recognises the importance of not alienating the members of the pension funds, from the ultimate management of their money, by requiring their managers to ensure that the corporation's management complies with the code.¹⁵⁷

¹⁵⁴ See ante.

¹⁵⁵ This proposal was made by The Ontario Securities Commission (OSC) informally before the decision in Inco was made, that a pill would only be accepted with the approval of the shareholders.

¹⁵⁶ See ante Chapters 5, 7 and Chapter 9.

The PIAC code recommended inter alia that public companies have a board composed of a majority of 15 members, with a majority of members being independent outsiders. Each board should also have nominating, audit and compensation committees, controlled and headed by outsiders. The role of the Chairman and the Chief Executive should be split, and the code also calls for the rejection by shareholders of certain types of stock option plans as forming a part of the overall remuneration of directors.

The code goes on to denounce poison pills, unequal voting rights and staggered boards. Clearly the code bears some resemblance to the Cadbury Code, but these denunciations go further to give some clarity over the perception of the poison pill on the worth of shareholder stakes. This represents an expectation gap between the shareholder representatives and the courts who still see the poison pill as a moot point of law which can actually work in favour of the shareholder even if this is a secondary consideration.¹⁵⁸

The code does not however incorporate some of the recommendations of the Fairvest Submissions.¹⁵⁹ These included the board being no more than twelve members and that the directors could sit on no more than seven boards and that there should be enhanced executive pay disclosure. What it was particularly critical of was the way in which the shareholder was only able to submit resolutions every three years to the management and called for an enhancement to the shareholder's voice in the corporation.

These discussions illustrate that the problems of governance and the incorporation of the different groups in the corporate nexus are shared throughout the Western commercial markets, and the role of the shareholder in particular is a cause for concern amongst the corporation's management.¹⁶⁰

¹⁵⁷ See inter alia, "Measuring up in Canada: Pension Group Creates code for Corporate Governance", Marlene Givant Star, Pensions and Investments, April 18, 1994.

¹⁵⁸ See ante.

¹⁵⁹ Fairvest Securities Corporation is a Toronto stock brokerage firm specializing in corporate governance, formerly called Allinvest Group Ltd.

¹⁶⁰ See "Shareholder Communications at the Annual General Meeting": A Consultative Document' The Department of Trade and Industry. April 1996.

For Canada however, the position of the shareholder in the corporation has received further enhancement through the Toronto Stock Exchange's announcement that it is adopting additional listing requirements.¹⁶¹ These requirements will necessitate the corporation to give an annual disclosure of its approach to corporate governance. Particularly important is the fact that corporations are to give explanations for differences between different corporate systems, and differences with the guidelines contained in the TSE Committee on Corporate Governance in Canada (the Final Report).

The announcement of the guidelines illustrates an increase in awareness in the need for improved corporate governance across Canada. The TSE has made recommendations that their guidelines be discussed with other stock exchanges in Canada with a view to adopting similar guidelines.

The requirement to disclose however, is less onerous than the British requirement illustrated in the Cadbury Code, which requires corporations to "give reasons for" any areas of non-compliance with the Code of Best Practice.¹⁶² There is as yet however no evidence to compare the detail of the corporation's response to the disclosure requirements of compliance with those found in the UK. It may be that with a less onerous requirement to disclose the corporation may be more willing to furnish more detailed accounts of corporate inconsistency and peculiarity in its governance structures than the often perfunctory and brief pro forma type of response which has been the focus of much media criticism in the UK.¹⁶³

The code recommends fourteen (14) guidelines some of which are similar to those requested by the PIAC in 1994.¹⁶⁴ Most importantly is the recommendation that the majority of directors on the board be unrelated.¹⁶⁵ The thrust of this measure can be seen to be mitigated when one

¹⁶¹ Announcement made in February 1995.

¹⁶² See para 3.07- 3.10 of the Cadbury Code of Practice.

¹⁶³ See inter alia: John SM Turner and Fasken Martineau, "Canada : Toronto Stock Exchange Adopts Corporate Governance Listing Requirement", International Briefing, Butterworths Journal of International Banking and Financial Law, April 1995.

¹⁶⁴ See ante.

¹⁶⁵ Schedule A2 of the TSE guidelines.

considers that an unrelated director can in fact be one that receives an income from the corporation. This then may not provide a framework for creating truly unrelated directors with a detached perspective of the corporation and its board.

The second part of the recommendations, set out in Schedule B of the of the TSE's guidelines recommends a change in the corporate law of Canada firstly to eliminate the suggestion that directors are responsible for the day to day running of the corporation, secondly that all legislation imposing personal liability be reviewed with a view to removing liability which does not serve its purpose. Thirdly, to impose civil liabilities upon directors for failing to give continuous and timely disclosure of the corporation's activities.

Clearly, a balance is being struck between the acceptance that directors should be protected if they act with due diligence which would be a defence to any civil claim, while making sure that through the implementation of certain structures in the corporation a constant and consistent appraisal of the board's activities can be made.

CHAPTER 10

CONCLUSION

The remit of this thesis is to identify the reasons for the particular and idiosyncratic development of the creation of legal standards of behaviour for corporate directors, and to assess the appropriateness of that standard in relation to the director himself and to those in the corporate nexus who are affected by his actions. In assessing the development of directors' duties both inside and outside the UK, it was important to furnish recommendations as to the direction in which the further development in this area should take. In this vein several observations had to be addressed. First, is the current area of insolvency law an appropriate one to use in establishing an objective standard of care and skill for directors and is the expectation of it too ambitious? If so, what developments can be made for the creation of further directors duties to remedy any expectation gap which exists between directors, shareholders and other groups in the corporate nexus?

Second, is the question of making objective the standard of directors' duties sufficient to bridge that expectation gap or is it necessary to look at other structural devices within the corporate framework which will complement any changes in the intrinsic standard for director behaviour.

Finally, is there a need for a radical restructuring of the very concept of 'corporation' and 'director'? In assessing this last point we should conclude what principles can be engineered to create better corporate governance which express the eclectic qualities of the modern corporation.

Post war development of company law in the UK has emphasised the input of non-statutory regulations highlighting two important objectives. First, there is the requirement to limit the

power of the judiciary to develop detailed criteria for the establishment of standards for directors and management in general. The objective is to create greater flexibility in establishing principles for governance. Second, the need to establish an alternative system of regulation to both statute and common law development which will maintain public confidence while at the same time provide a working formula for the complex world of commerce to recognise as good practice.

The judiciary has responded to the problem of initiating such non-statutory regulation by exercising commercial decisions in areas of company law.¹ This is not surprising as the basis of many legal interpretations in companies legislation will reflect some degree of sensitivity to the commercial effect of that particular decision. It is with this background that the judiciary's interpretation of the Insolvency Act 1986 is considered.

The Insolvency Act itself was initiated not as a proactive panacea to all the consequences flowing from a company facing financial difficulty but as a combination of different and often conflicting objectives.² The need to facilitate a more pro debtor system of legal response to corporate failure, is illustrated in the enabling provisions allowing the company to seek more easily a voluntary

¹ In particular the judicial interpretation of exercising good faith in a commercial context, is illustrated in the concept of altering the articles "bona fide for the benefit of the company as a whole" [Lindley MR in *Allen v Gold reefs of West Africa Ltd* [1900] 1 Ch 656 at pp 671-2.] This requires the judge to look at the commercial well being of the company as well as its members and affords the judge with a wide practical stance on the principle. Contrast the cases of LJ Banks in *Shuttleworth v Cox* [1927] 2 KB 9 CA, where the shareholder was emphasised as being the person who decided what was in the best interests of the company, and *Brown v British Abrasive* [1919] and more controversially *Dafen Tinsplate v Llanelli Steel Co. (1907) Ltd* [1920] 2 Ch 290, where the judge was very pro-active in deciding the remit of what was in the company's best interest. This pre war history of judicial discretion was carried forward in many post war cases, but the concept of acting in good faith, and the concept of the corporation has had varied interpretations, for instance, *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62 [1969] 2 All ER 1185 (Chancery Division). Here a breach of duty did not compromise the principle of capacity to act in deciding a transaction to be ultra vires. In this case the corporation was viewed as a separate legal entity which had a capacity divorced from the intention of the directors. In the case of *Parke v Daily News* [1962] Ch 927 [1962] 2 All ER 929, the corporation was viewed as the interests of the shareholders as a whole, thus indicating one particular tangent to the director's duty to act bona fide for the benefit of the company.

arrangement with the purpose of saving the corporation.³ The use of this device has increased nearly tenfold since its inception in 1985.⁴ The use of the Administration Order⁵ has similarly shown that the corporation as debtor has a significant effect on the underlying approach towards insolvent corporations and their officers. Here the importance of the corporation as tax payer and employer is clearly emphasised.

The provision of wrongful trading is to be found in the other objective of the eclectic Insolvency Act 1986, in attempting to raise the standard of director's performance and thus creating greater protection for the creditor. Its initiation was designed to bring within the remit of legal sanction, those directors who through negligence and lack of understanding caused loss to the creditor. The section was sensitive to the fact that within the relationship of creditor and director there is an element of risk which affords certain margins for the director to have discretion over the creditor's money but that once that discretion reached a particular point which negated the creditor's security, then the director would be responsible for ensuring that the creditor's interest was placed first.⁶

The relevance of subsection (4) of S.214 Insolvency Act 1986, is that in achieving the above assurances, an objective criteria for director's behaviour was presumed, and then taken out of its original context, to be used as a general standard for director's duty of care and skill.⁷ There are several important observations to make about the use of S.214 in this way.

First, the section is designed to protect the creditor in his relationship with the director. This relationship presumes that the creditor will view with caution and even concern, the actions of a

² See ante at Chapter 2

³ Sections 1-7 Insolvency Act 1986, make the procedure for voluntary arrangements much easier than the previous provisions under s245-247 Companies Act 1985.

⁴ See ante Chapter 4.

⁵ Sections 8-27 Insolvency Act 1986, which is used in order to facilitate a more secure voluntary arrangement. As they effect a moratorium over the corporation's assets.

⁶ *ibid*

director who incurs credit in a situation where the company is insolvent. Yet there are occasions when a greater degree of credit will be incurred and with it a subsequent greater risk of failure which may be encouraged by the creditor. The concept of risk is a commercial one and the commercial spirit of one creditor may be more cavalier than that of another. To assess the relationship as always being asymmetrical in terms of encouraging commercial risk and the responsibilities for that risk as well as the orchestration of it, is to disregard the economic aspirations which encourage both nexus groups (director and creditor) to demand increased risks which may involve incurring credit at a time when the company is insolvent and for the creditor to agree that risk in the hope of obtaining a better return on his initial investment. It is the director however who under the provision of S.214 remains liable for any loss.

For the director, this means that he cannot always comply with the expectations of his creditors as he will always have an eye on section 214 Insolvency Act. In practice however we have seen that this section is not understood by many in the commercial community and thus its preventative measures will not be translated into director action.⁸ The result is that the section loses credibility as a standard raising device for those who do not know of its provisions while at the same time can act as an intimidating device for those who wish to carry on trading with their creditor's consent in order to keep the company afloat. In both scenarios, the section circumvents the idea of accountability.

The problems surrounding the implementation of wrongful trading illustrates the difficulties in interpreting the legislation and the financial difficulties of bringing the case.⁹ Section 214 Insolvency Act engenders an objective perspective of the director's standard of care and skill. Nevertheless, it fails to consider the question of whether an objective standard means one standard or if it is one standard subject to the resources of the corporation and the calibre of

⁷ See *Re D'Jan of London* ante Chapter 3

⁸ See ante Chapter 3 and the findings of the Insolvency Service's Report 1993

⁹ *ibid.*

people at the disposal of the director. This would mean that several levels of performance and due diligence would apply to directors depending on their corporation's size and resources.¹⁰ For instance a lecturer may set as the required standard for his exam, the level that every student does his best (an objective standard). Each student diligently performs to the best of his ability but on return of the papers the lecturer has twenty different levels of performance which have been fashioned by the students own ability and personal circumstance.

For Knox J. in *Re Produce Marketing Consortium*,¹¹ the corporation's resources were an important consideration in determining whether the director had exercised his duties of care and skill within the parameter of the new wrongful trading provision, yet no criteria is given as to what amount of resources available to a particular corporation will necessitate a particular standard of care from any one director. In trying to establish such a criteria the courts would have to develop further their ability to make a judgement on a commercial basis which may define whether something wrongful has taken place and if so who has been wronged and by whom. The momentum of non-statutory regulation and the recognition of the law's minimalist approach to the development of *inter alia* the legal definition of director's duty of care and skill indicates that this is an inappropriate and maybe impossible task for the judiciary to perform.

In creating an objective standard for directors s 214 Insolvency Act 1986 suggests that a single set of criteria can be used to assess whether a director has fulfilled his legal or even moral obligations to the creditor. With the relationship between the two groups depending on the conservative or cavalier nature of both directors and creditors in their attitude to corporate policy such an aspiration will prove difficult to distil into one legal concept. If this is true for the relationship of directors with one group in the corporate nexus then even further difficulties will arise with the directors' relationships with the other groups such as shareholders, employees and third parties,

¹⁰ See ante Chapter 3 and 4.

¹¹ See ante Chapter 3.

who are to benefit from the application of an objective criteria for *inter alia* directors' care and skill.¹²

From the evidence of case law, statute and non-statutory regulation, the development of directors' duties can be assessed in terms of piecemeal attempts by the judiciary, Parliament and the City to react to the changing requirements of trade and industry. In particular the need to address the void which exists between shareholder and director - the orthodox but certainly not the universal definition of corporate governance.¹³

The nature of wrongful trading, indeed its very title suggests a degree of culpability which will warrant the payment of damages to compensate for the wrong done. Yet with the concept being used more broadly, and the poor number of cases that followed its inception, the conclusion has to be that it has not provided the companies and those within its nexus with a holy grail for good standards of director performance. The problem is not just that a wrongful act has occurred but that the definition of wrongful carries with it the same subjective factors associated within the relationship of the director and the creditor as well as the substance and resources of the particular company.¹⁴

It is here that the court's response to the powers of disqualification within the Company Directors Disqualification Act 1986 may be considered as an indication of the court's ability to respond to the varying degrees of culpability which will result in the director being disqualified, exonerated, or as a compromise, controlled. The discretion to look at his performance overall in several different companies currently afforded by section 6 of the CDDA, could be extended to section 10 CDDA¹⁵. This discretion, narrowly extended to improve section 10 CDDA may be expediently

¹² *ibid.*

¹³ See ante Chapter 5.

¹⁴ See ante Conclusion.

¹⁵ This provision affords a disqualification order to the court to be made against a director who is liable for wrongful trading, under section 214 Insolvency Act 1986. See ante Chapter 4.

extended into other areas of corporate law relating to the monitoring of director's duties in order to create a greater circumspection, balancing the development of director's duties with the objective of preserving enterprise and recognising the concept of risk taking as a legitimate consequence of investment. In failing to employ such discretion, wrongful trading is both draconian in its application and produces reservations amongst the judiciary to implement it. This has further undermined those objectives of the Cork Report which were an integral expectation for commercial morality.

A further major consideration of the Cork Report was to prevent the abuses of the insolvency process by those who saw it as a means of taking assets away from the corporation and thus its creditors¹⁶. The provisions of the Insolvency Act 1986 which illustrated this objective were not as far reaching as the Cork Report had requested.¹⁷ Nevertheless, they were a reaction to the political damage that the more extreme cases of director mismanagement of funds were causing to the ethos of the new entrepreneurial era initiated at the beginning of the 1980's. In this respect they were not intended to act as a general strategy for good corporate behaviour, but merely to reform those aspects of insolvency which were seen as representing a "jungle" mentality to credit, serving to undermine confidence in the growing number of smaller corporations.

The use of S.214 Insolvency Act 1986, is an opportunistic way of developing a statutory standard of care and skill for the general duty of directors. No doubt the fact that directors' duties have traditionally been politically unimportant has acted as a catalyst for such opportunism as specific statutory provisions to enhance directors' duties have been overlooked¹⁸ but the consequence of that opportunism has been to produce a provision which has produced a dichotomised interpretation from judges and academic commentators who have recognised both the civil and

¹⁶ See ante Chapters 2, 3 and 4.

¹⁷ See ante at Chapters 2 and 3.

¹⁸ Section 13 Supply of Goods and Services Act 1982 exonerates a director from liability for failure to comply with the concept of reasonableness in the execution of his duty to act with care and skill. See ante Chapter 6.

quasi criminal aspects of the provision ¹⁹. The further development and refinement of corporations and the advent of popular capitalism changed the political atmosphere in this area, and perhaps in this context, wrongful trading was in the wrong place but at the wrong time.

The use of wrongful trading can prove more burdensome than helpful in retrieving assets for the creditor and it also remains uncircumspect to the fact that a director may come within its technical remit but can also remain an integral and prolific director whose position determines the future of employees in another corporation of which he is director. Britain today demands that the spirit of enterprise be fanned by industry and law. This provision rests too heavily on the objective of policing directors activities and in doing so implodes itself to become a legal artefact that is neither often employed or respected.

The provision clearly has an identity crisis in terms of its philosophical objectives. The provision was clearly intended to be a preventative measure, by which the director of a corporation would raise the standard of his skill and care in order to avoid being subject to personal liability for company debts²⁰. However, the Insolvency Service's findings indicated that the provision would not create such a climate because it was sporadically understood and similarly respected²¹. Such figures were confirmed by my own findings even though the general attitude of directors was one of a willingness to learn about those legal principles which could raise the corporate veil and render them personally liable.²²

The result is that wrongful trading becomes less preventative in its input to the general governance debate and its ability to act as a policing device undermined by its inability to compete with the other preventative measures which have been orchestrated in the name of good

¹⁹ See ante Chapter 6

²⁰ See ante Chapters 2 and 3

²¹ *ibid.*

²² The concept of continued training is thematic to good governance and was recognised by the Cadbury Report and the report of the Hampel Committee.

corporate governance. As a curative measure it is undermined both by the cost of implementing it and the confidence of the Insolvency Service to bring a claim under it.

So where can the commercial community including investors, creditors, employees and the beneficiaries of the taxation system look in order to find those preventative measures ? The Cadbury Code as the major alternative to legal threats emphasises the need for preventative measures within the corporate structure to ensure good board practice, and to prevent adverse shareholder reaction when the communication system between the two groups breaks down²³. The effects of poor communication between directors and auditors, was displayed in the extreme in the Queen Moat House disaster²⁴. The emphasis here was on the need to ensure that as the corporation grew and particularly where that growth was quick, there were appropriate levels of restructuring in the corporate body to ensure the integrity of the board and to fulfil the expectation of the others within the corporate group.²⁵

The report into the Queen Moat House crash, indicates the need for the corporation to evolve in its structure as it grows and becomes both more powerful and socially as well as commercially responsible. In this respect it displays similar concerns to those surrounding the wrongful trading provision in that it recognises the diversity of the corporate form and the fact that the corporation's resources are an important part of establishing the appropriate levels of governance.²⁶

Appropriate levels of governance, which fulfils commercial and social expectations as well as initiate an effective and practical legal objective will thus not be completed with reference to one

²³ See ante Chapter 7. In particular, the survey undertaken by Manches & Co. Solicitors which has been confirmed by Alice Belcher "Regulation by the Market: The Case of the Cadbury Code and Compliance Statement." *The Company Lawyer* 1996. Vol. 17 No.1. Here the problem of creative compliance is considered as corporations try to ostensibly comply with the provisions of Cadbury, while taking advantage of the fact that it is not mandatory.

²⁴ *ibid.*

²⁵ *ibid.*

legal formula. Principles of governance will provide a bare minimum for behavioural standards, and this has to combine the commercial efficiency of the corporation with its respective duties to its nexus groups. The small corporation may wish to relax legal requirements on meetings and shareholder information,²⁷ whereas larger corporations will have to ensure that these aspects of its governance strategy are more strictly adhered to and can respond to the broad based share ownership of the corporation. While principles such as independent monitoring and communication can be requested by *inter alia*, Cadbury, the fact remains that the resourcing issue for each company will remain subjective dependant on the corporation's own development and experience.²⁸

The Queen Moat House scenario indicates only one particular problem in the law's relationship with the corporation namely that large public corporation have the difficulty of maintaining a strong input from the shareholder in the management structure. The legal powers residual to the shareholders are undermined by the fact that the shareholders cannot form one effective voice. The questions for governance in such a scenario are far different from those of a smaller corporation or even a quasi partnership in which the Board and shareholders are closely related or even almost inter-changeable. Yet even here the ability of the shareholder to act as an objective and integral monitoring force is undermined by the fact that shareholders will have a profit orientated agenda which might applaud certain aspects of bad practice by the Board where bigger profits will result.

This raises the question of whether the corporation be perceived as one legal concept fashioned in eighteenth century property rights responding to the requirements of particular social groups. Rather it would be expedient to redefine the institution of the corporation responding to the judiciary's attempt to further develop special provisions for the smaller corporation and the

²⁶ Chapters 6 & 7.

²⁷ See Sealy, "Company Law in a Changing Commercial Climate" The Company Lawyer Lectures, Institute of Advanced Legal Studies, December, 1996.

regulators for providing extra control for the large enterprises. This can be achieved through the creation of different types of corporations onto which particular legal devices designed to give appropriate guide for good governance would be super imposed. The ability to establish some objectivity will be increased by reducing the number and types of corporation to which it should apply.

In this vein we establish two very important principles of governance. First is the development of improved communication between the different groups in the corporate body whose traditional role was to act as a check on each other. Second, that the efforts to ensure that these communications are effective and are not burdensome to the corporation reflecting the size and resources of the corporation. However, where there is a quickly growing corporation the paramount principle should be effective communication which reflects the rapid commercial growth. The Queen Moat House scenario, albeit acute in its illustration, displays the need for this prioritising.

The need to establish some guidelines for directors of different sized corporations is endorsed by the response to the provisions of Cadbury and Hampel. The Code/ Recommendations highlight two major elements in the attitude of corporations to the concept of governance. First, that the financial consequences of implementing the Cadbury provisions mean that corporations will vary in their capacity and determination to implement all of the provisions.²⁸ A corporation which has alternative structures for governance will be ambivalent to the imposition of a prescriptive code. The cost of restructuring will be perceived as a pointless exercise merely affirming the corporation's commitment to appropriate governance structures.

²⁸ A view illustrated in the report of the Hampel Committee See ante Chapter 6 and Appendix 3.

²⁹ See ante Chapter 7. In particular the figures by Manches and Co. on the implementation of the code's provisions.

Second, that conceptually the code / recommendations are preventative measures in trying to adopt structures which will enable the corporation to develop open and comprehensive strategies for corporate management. Important in this objective is the communication with others in management, including shareholders and their representatives. Their ability to have independent monitoring of management is presumed but cannot always be trusted.³⁰ This is in contrast to the curative effect of using the Insolvency Act provisions as a mechanism for the same objective.³¹

However, the Code's ability to persuade corporations to adopt such objective monitoring measures are severely compromised by the inter-action between executive and non-executive directors and the fact that within many of the sub groups proposed by Cadbury there is an overlap of personnel. This means that often individuals will wield greater power than Cadbury wished as their influence grows in these sub committees.

The code's inability to act as a universal device for good corporate governance as envisaged by its authors is due to the fact that the code's objectives while designed for those large broad based corporations listed on the stock-exchange' nevertheless expected to influence other corporations as well.³² Corporations outside the larger company category were expected to take on board the provisions of the code with the hope that they would also implement its recommendations.³³ Yet, the code required further armoury in its objective of being universally implemented on the Stock Exchange. This was achieved in part through validation from the Yellow Book.³⁴ In applying such a prescriptive approach the code like the Insolvency Act 1986, has failed to recognise the need for greater sensitivity towards the corporation's capacity to implement its provisions. A universal set of principles for governance is too optimistic and uncircumspect.

³⁰ See *inter alia* Fischel Chapter Nine.

³¹ See ante .

³² See ante Chapter 7.

³³ *ibid*

³⁴ Section 12 "Stock Exchange Listings Rules" made the compliance statement with the code compulsory , after the new issue was published in December 1, 1993. This fulfilled

For corporations not covered by the Yellow Book, guidance for good governance has not been dealt with on any quasi statutory level³⁵ but works published by the Institute of Directors which are aimed at the medium sized corporation³⁶ show that it is important to further develop criteria for the governance of medium and smaller corporations. The already mitigated lustre of the Cadbury code is further tarnished as broad principles are not translated into detailed criteria which would be the remit of a statutory schedule. This raises the fundamental question of whether allowing self regulation to develop standards of good corporate practice is expedient. The idea that Cadbury has a soft centre,³⁷ sees the legislative process as important in hardening the impact of the code on the corporate community.³⁸ In order for the Code to bight, statutory provisions with effective sanctioning for non compliance is essential but the importance of not over regulating or finding inappropriate levels of regulation must be taken on board as well.

The implication of a statutory device to enhance the standards expected from directors would benefit from a review of the nature of the corporate form and responsibility. This is a priority for all other legislation dealing with director standards and governance. The idea of a stakeholding corporation broadens the responsibilities of the company and challenges the traditional focus of directors' duties from a profit motivated objective designed to enhance the capital security of the

recommendations from inter alia, the Accounting Standards Board who stated that compliance ought only to be compulsory when the code itself was compulsory.

³⁵ See *Re Chez Nico (Restaurants)*. Chapters 6 & 7 ante.

³⁶ See ante Chapter 7, particularly the report published by Henley Management College, on guidance for good practice for directors.

³⁷ Amongst those who see the way forward is to implement legislation is the Law Society which state "We consider that the law relating to the duties of directors is an area of company law which should be reviewed in depth as part of the exercise of raising standards of corporate governance. It is only after such a thorough review which can examine all the implications of legislative change and their interaction with other areas of company law that legislative reform would be appropriate." Memorandum No. 271 July 1992.

³⁸ One of the latest surveys undertaken by the Pension Investment Research Consultant found that 47% of corporations had complied with Cadbury fully, but that there were still various important outstanding issues which corporations were not addressing and which were central to the Cadbury theme. For further reading see *The Company Lawyer* (1995) Vol. 16 No.3.

corporation to a performance related objective designed to enhance the profile of the corporation in the area of good citizenship which encompasses a broader nexus group.³⁹

This does not mean that the corporation abdicates its responsibilities to its shareholders and creditors, as maximising corporate profit will remain at the forefront of the objective for corporations.⁴⁰ Rather it defers to the idea that within the objective of maximising profits there is the overall performance of the company to consider. The objective of the law is to define what those considerations are and then go on to ask whether they can be universally applied to the corporation or need refinement, according to a particular corporation's size and management experience. The focus is currently too broad, too universal. Efforts to hone in on the needs of particular corporations is essential. Nexus groups may have different legal obligations or expectations depending on the original focus and ambit of the corporation. These have to be considered in the process of initiating guidelines for management.

In order to achieve such an objective a return should be made to the traditional view that the duty of the director is to the corporation.⁴¹ This will presume however, that the corporation itself has changed to become inclusive expressing duties to all those within the corporate nexus at least. Corporations such as Cadbury Schweppes, Guinness, Thorn EMI and Whitbread have already embraced this 'inclusive' conception of the corporation.⁴² However, to distil these voluntary arrangements into a universal demand for the corporation to comply with, is to presume that the corporation is one legal form requiring one legal application of governance.

³⁹ For further discussion on the development of directors duties see ante Chapter 4.

⁴⁰ See ante Chapter 5. The response of corporations to the question of what was the most important objective in the corporation signalled a response which indicated that performance had been accepted as the most important objective but that profit was an integral part of this.

⁴¹ See ante Chapter 4.

⁴² The Royal Society of Arts organised a survey included in the "Tomorrow's Company" inquiry (1995), which illustrated that these firms were more open in their approach to the idea that the corporation as changed conceptually within society and that as a result responsibility of management should change accordingly.

This clearly is not the position either in law or even more dramatically in fact.⁴³ The approach of the law relating to the corporation in the Anglo-American tradition is to emphasise the contractual obligations between the different groups in the corporate nexus and then to extend the legal responsibility of that contract when it was expedient. This has led to an *ad hoc* evolution of standards for the director created by statutory and non-statutory regulation.⁴⁴ For the German and Japanese systems however, a more socially rounded view of the corporation as a public institution has been fostered which has aspirations of its own set apart from developing the cause of one group within the corporate nexus, for example, the shareholder.⁴⁵ As a result, the focus of management is broadened to include a more universal benefit for the corporation and others within it. Corporations are :

*“perfectly naturally perceived as ... social institution[s], with public responsibilities”.*⁴⁶

The difficulty of changing the standards for good governance within the UK, emphasises the difficulty in changing the concept of the corporation itself. The political perspective on the role of the corporation as defender of private property and private enterprise, inhibits the growth of the idea that this concept is one of only a number of concepts which are an important part of the concept of the corporation. The hostility to the proposal of worker's participation in management,⁴⁷ underlines the political reaction to any degree of change which illustrates a broadening in the corporate ideal. The polarity which is an inevitable consequence of such a tunnelled view in the UK has developed the direction of management to one which is exclusory and ambivalent to the social and economic changes which were the products of the share ownership boom of the Thatcherite era.

⁴³ See ante Chapters 5 & 7.

⁴⁴ See ante Chapter 4.

⁴⁵ Ireland “Corporate Governance, Stakeholding, and the Company: Towards a Less Degenerated Capitalism?” *Journal of Law and Society*, September 1996.

⁴⁶ *ibid.*

This is perhaps because of the nature of the nexus group which is being advocated for inclusion. The history of the Thatcherite era saw the proposed inception of the works councils at a time when the prosperity of business depended in part on the ability to restrict the power of the unions. This created a attitude of at best reluctance and at worst ambivalence to anything which compromised the power of management to express the new enterprise culture, particularly by implementing a structure perceived as trades unionism through the back door.

It is ironic that some corporations have taken the initiative and included a works council, despite the UK's long history of rejection of it in Europe and successive government's continued ambivalence to the German model of corporate structure, which gives power to the employees through the supervisory board.⁴⁸

If the German system is to be considered as extreme in its form this does not prevent a more moderate use of employees in UK management. The introduction of the works council is an ideal opportunity to test whether the inclusion of workers in the management process in some contained context would result in a positive blue print for further inclusion, somewhere between the all powerful supervisory board and the works council. The most persuasive argument against inclusion of a system akin to the supervisory board is that its powers are not reflected in the responsibilities which are attached to it.⁴⁹ To define levels of responsibilities for such a board would undoubtedly follow some of the same considerations as those outlined for day to day management responsibility.⁵⁰ Thus a two tier system could be employed but modified so that the powers undertaken by the shareholders will in fact be complimented by a more appropriate level of responsibility.

⁴⁷ See ante Chapter 8.

⁴⁸ *ibid.*

⁴⁹ *ibid.*

⁵⁰ Ante Chapters 4,5,6 7&8.

The effect of establishing such a board would be to create a greater degree of circumspection between directors, shareholders and employees who are at the centre of the governance debate. Such a restructure would be more inclined to fulfil the performance related criteria which has been advocated as the future of the corporation⁵¹ and to develop the new concept of the company as a public interest. For the larger corporation the pressure of public opinion which is undoubtedly increasing can be channelled in such a scheme.

This concept is justified on the basis that whether directly through small investment or through the use of the investment institutions, the public's money plays an increased role in the equity of listed corporations.⁵² This has increased the interest shown by the public to the way in which management structures are monitored. Yet there may be a danger in focusing on the expectations of the new shareholder in treating the public as a consumer who expects to get a degree of certainty in their investment coupled with a management structure with the objective of maximising that investment. The shareholders may be ambivalent to that objective being compromised by the corporation's new social responsibilities. Like the 1832 Reform Act, the shareholder may want a more selective enfranchisement of the corporate system than that advocated by Berle⁵³ which may resemble the extension of directors duties along the same line as that undertaken in Commonwealth countries, and which has found form in the City Code of Takeovers and Mergers.⁵⁴

Thus in extending the duty for directors a balance has to be struck which appreciate the needs of all those within the corporate nexus and not just one particular group which has traditionally both in law and in fact been allowed residual powers of management influence.

⁵¹ Supra 35. In particular, the comments by H. Collins "Organisational Regulation and the Limits to Contract" and McCahery, Picciotto, and Scott "Corporate Control and Accountability" (1993).

⁵² See ante Chapter 7.

⁵³ See ante Chapter 4.

Australia, through the initiation of The Life Assurance Act 1995, indicated that within certain enterprises, the metamorphosis of shareholder as consumer is justified, in preventing fraud, thus placing the shareholder's interest in priority to that of any other group in the company.⁵⁵ The use of personal liability to prevent the director from giving misleading information to a client⁵⁶, is mitigated by the defence that due diligence was taken in giving that information.⁵⁷ Yet with less security orientated investment objectives, can this high degree of shareholder orientated duty be universally applicable? A shareholder ceases to become a client or a consumer once he has taken up position in the company. Rather he is an investor in a social institution which has the ability to make great profits but like any other good citizen has responsibilities to his peers.

The shareholder's position does however act as a touchstone to the problem of conceptualising the corporation in law. Clearly, the arguments surrounding the concept of the stakeholder company reflect the change in corporate involvement in society but that fact is expressed only in the larger or listed corporations. The expectations of the directors, shareholders and employees in smaller corporations will have less politically charged agendas for change and can gain access more easily to the current procedures for shareholder and employee redress, than counterparts in the large corporations.⁵⁸

Gaining access to these remedies will be an important development for shareholders in listed corporations. The institutional investors may need to put in place a more effective system of

⁵⁴ *ibid.* In particular the case of *Re Chez Nico Restaurants Plc.*

⁵⁵ See Amanda Morgan "Life Insurance Company Directors: Beyond the Call of Duty?" *Australian Business Law Review*. Vol. 25 . February 1997.

⁵⁶ Section 32 Life Assurance Act 1995.

⁵⁷ Section 48 Life Assurance Act 1995.

⁵⁸ *Ibid* and Chapter 5. In particular the use of section 303 Companies Act in relation to director dismissal and Section 459, relating to unfair prejudice.

monitoring which reflects the expectations of those investing, as well as their increased motivation to secure their voice within the corporation.⁵⁹

The emphasis for the law is to clarify the type of corporations which will come within the remit of certain governance obligations, for clearly the factual metaphysical nature of the corporation is not being responded to by a statutory change in the standard of directors' duties. The need to use a provision in the Insolvency Act as an annunciation of the new standard for directors is indicative of this.

The impact of history and social structuring has created corporate idiosyncrasies that can be identified by national boundaries.⁶⁰ These have developed into a guarded and often hostile attitude to the structures of other corporations within the same economic and socio-political groups. The position of the UK in the broader European debate on the participation of workers in the management structure of corporations has displayed a political ambivalence which is now coming to an end with the advent of the Blair administration and the impending signing of the Social Chapter and annexed documents. This political move is following the corporate and cultural shift towards a greater acceptance for worker participation, although again the theme of being sensitive to the resources of the corporation will be viewed in deciding whether the fact or degree of worker participation is appropriate.

To change the nature and concept of the corporation within society therefore is to change the attitude of that society itself to the objective of the corporation. In Britain, this has partly been achieved by the alteration of share-ownership amongst the small investor, and the growth in private pension funds and other savings devices. Yet the passivity of many shareholders in the context of their potential management duties reflects the polarised perspective of the ordinary

⁵⁹ The issue is discussed in "Private Shareholders: Corporate Governance Rights - A Consultative Document." Department of Trade and Industry, November 1996.

investor, to the seemingly autonomous director whose legal restraints have been mitigated by the failure of the law to recognise the change in the financial make-up of large corporations in the eighties and nineties.⁶¹

These failures do not seem to reflect the wishes of management to be perceived as a group ignorant of their legal responsibilities.⁶² Rather, the future of broad based share owned corporations depends on the ability of corporate managers to maintain confidence in their investors and to recognise the broader remit of corporate responsibility and accountability.⁶³ Most importantly this means that the directors steer away from those who are speculating in the short term for instant profits and respond more to the objectives of those whose commitment to the corporation is long term. This will produce a more circumspect and far sighted director who will be in a position to see the corporation as a citizen with a range of responsibilities to its internal members as well as the broader society.

In this context, legislation based on a further refinement in the categorising of the corporation *de jure* rather than simply *de facto*, could superimpose onto that categorisation relevant training and qualifying provisions as well as codes of recommended practice that could both fulfil the legal obligation of the director to the corporation (with its new conceptual basis) as well as provide those affected within and without the corporate nexus with the assurance that as the corporation grows there are recognised legal structures and training designed to keep governance within the corporation intact but sensitive to the corporation's resources and internal structure.⁶⁴

⁶⁰ See ante Chapter 8, particularly, the impact of the evolution of the German and French corporate systems.

⁶¹ Figures for changes in the corporate structure are found in Chapter 7.

⁶² See ante Chapter 6. The returns to the questionnaire indicated that directors would see legal training as an integral part of their future management role.

⁶³ *ibid.*

⁶⁴ DTI Consults on limited liability partnerships, Joanna Gray, (1997), *The Company Lawyer*, Vol. 18. No.4. Here, a new form of corporation is considered for the professional partnership,

In this respect the statutory provision and the code of recommended practice would harmonise. The statute would provide the particular legal standards for a director of a particular corporation to attain, based on the corporation's size and resources. Such provisions would include the standard of care and skill expected in that corporation as well as the communication requirements with shareholders and relevant board structures if necessary. The codes would then complement this statutory core of information by providing advice to the corporation as to how best it can fulfil those statutory objectives.

Like the present relationship between statutory provisions and regulatory codes of best practice, this relationship would leave some discretion to the corporation to fulfil its legal duties but the compulsory element of the law would always remain as the ultimate objective and the discretion to implement the recommended codes would not create the undermining effect that has characterised much of the commentary on the implementation of present non-statutory codes.

The objectives of governance, reflecting the evolution of the corporation, are themselves metaphysical. The use of section 214 (4) Insolvency Act, 1986, as a means of common law development in the area of directors' duties and the implementation of non-statutory codes, culminate to achieve a national response to the particular needs of both the commercial community and the broader society. Yet this is only a part of the governance process.

The relationship of the UK and other European countries, as well as the objectives of the European Community as a political entity, mirror some of the problems found in balancing the requirement of commercial freedom, with the increase in concern with the power of management, and its relationship with others in the corporate nexus.⁶⁵ First, there is the question of harmonisation and the extent of its ambit in the context of restructuring the corporation. Here,

and shows how traditional forms of corporate structure can be refined to meet the needs of a particular enterprise.

⁶⁵ See ante Chapters 8 and 9.

the proposed implementation of the German two tier system of governance found in its larger corporations displays an ideal which presumes a common economic and social background. This clearly has been an important factor in the transformation of post war Germany, with the more radical evolution of industrial structures, than those conservative attitudes which remained in the allied nations.⁶⁶

Yet this need not be a fatal blow to the harmonisation of governance throughout Europe, even where its economies have become more divergent through the emancipation of the former Eastern Block countries. What is important for any success in the harmonisation of governance laws and regulation within the European Community is that the ambit of the term harmony is correctly interpreted and that political discipline refrains from translating the concept to one of assimilation.⁶⁷

Extolling the German model as a paradigm, even a prerequisite for not only good governance, but dynamic governance reflecting the modern responsibilities of the newly conceptualised corporation is to undermine the positive aspects of other national governance structures which are working, albeit inconsistently in part, and which are carved from a tradition more evolutionary in its character than revolutionary. To assess UK ambivalence to the implementation of the proposed Fifth Directive and to Works Councils in terms of political anxiety alone is to ignore this fundamental problem of the European agenda. Nevertheless lessons can be learned from the German model and the use of the EC to cross fertilise ideas for governance places member states in a unique position to look at what is best about the different systems and harness ideas, even where they are subject to modification. Europe undoubtedly provides a forum for future development.

⁶⁶ See ante Chapter 8.

⁶⁷ *ibid.*

The US and Canadian approach to governance illustrates within their formalised federal structures the importance of harmonisation of governance controls in any economic block.⁶⁸ The establishment of one objective standard for directors, as well as recommended structures for corporate governance will undermine the “race to the bottom” scenario which creates incentives for states to have the most user friendly laws which will attract the patronage of a particular corporation.⁶⁹

Translated into the European context, corporations would feel more secure in the knowledge that the objectives which they had legally to obtain, were to be the general consideration of corporations throughout the community. This would take away any anxieties over unfair competition which results from a lack of monitoring within one particular jurisdiction which is prepared to see the inflation of short term corporate gains by allowing incorporation in a liberal atmosphere at the expense of creating corporate responsibility and a commitment to long term policies.

The Canadian perspective is important in assessing the subjective criteria of different states towards the question of management structure and responsibility within the remit of harmonised national governance with an objective of seeking objective standard practice. Like Germany, its traditions have resulted in its own shareholder structure and management role. Like Germany, it is a federal state which has incorporated both state and federal laws into its corporation laws. In this respect it shares some of the same distinctions with the USA as the UK does with Germany.⁷⁰

Yet both Canada and the US illustrate that in order to achieve governance which creates confidence as well commercial freedom the emphasis has to be upon establishing objective parameters of governance inside which there is a very subjective criteria for fulfilment. This

⁶⁸ See ante Chapter 9.

⁶⁹ *ibid.*

⁷⁰ See ante Chapters 7,8 &9.

phenomena is to be a characteristic of both national and international corporate law.⁷¹ Law has to be viewed as essential to the objective of effective governance but limited in the extent to which it can fulfil the expectations of shareholders, creditors, employees and society.

In Britain, the law's manipulation of section 214(4) Insolvency Act 1986, can be seen as unique in its involvement with the broader question of directors' duties. The USA has illustrated that even within its pro debtor insolvency regime it is necessary to provide for some redress against directors who have acted in a manner which results in a further loss to the corporation which was already financially vulnerable.⁷² Yet the USA have placed the role of liability for directors within the broader context of sustaining the corporation for the benefit of others within the corporate nexus. This has been a tradition in the USA which has not translated easily in the UK.⁷³

Nevertheless the increase in the UK of corporate saving devices in insolvency law suggests a cultural move towards a greater acceptance of risk taking as an integral part of management life and an understanding that directors should not necessarily be made liable for losses when things go wrong. Saving the corporation and improving its financial structure are illustrations of commitment by all in the corporation and not a device to give a director yet another chance.

The "workouts" in the US, which are analogous to the British Voluntary Arrangements, have been endorsed by other aspects of corporate law in particular the Business Judgement Rule. These devices, while not connected, do illustrate an underlying commercial philosophy which adheres to the stricter principles of *laissez faire*.

⁷¹ See Ante Chapter 8. In particular the proposed paper on the future of auditing as part of the broader issue of corporate governance within the European Community.

⁷² See ante Chapter 9.

⁷³ In the annual reports from the Insolvency Service, 1986-1996, the use of pro debtor arrangements such as the Voluntary Arrangement and the Administration Order, have been used more widely, only in the past three years. From 1986-1993, their small numbers indicated the lack of trust in the new philosophy towards insolvent corporations.

The Business Judgement Rule can be used by directors who reasonably believed that the policy decision they were taking was in the best interests of the corporation even when they were mistaken and the corporation ends up in further financial difficulty. The principle supports the philosophy that within the commercial arena there is legal as well as commercial justification for error and that within a culture disposed to the growth of entrepreneurialism this principle is to be valued through its broad application.

In the UK, the use of the wrongful trading provision illustrates a more circumspect culture towards those who are the contributors to corporate capital. This controlling element of the insolvency provisions has been criticised for being difficult to implement and ineffective as a policing device.⁷⁴ Yet perhaps its greatest vulnerability is that its inception came at a time when the liberal laissez faire attitude towards commerce was making a resurgence under the Thatcher administration. Its subsequent lack of use can be seen as a product of such a change in culture and thus a move towards a more understanding approach to risk and management error.

In this respect wrongful trading represented a respect for capital input that was out of pace with the newly developed sense of enterprise which could not justify quasi punishment in the cultural atmosphere of Anglo-American business. The paucity of cases indicates not only that the provision is for its own limited purposes difficult to implement but that broadened to cover the general statutory pronouncement on directors' duties, it completely fails to empathise with modern commercial needs or attitudes towards commercial failure.

The compelling argument for the provision still remains as a society which allows and even encourages free trade will always be punctuated with those rogue directors whose purpose is to manipulate the system for their own personal gain, leaving commercial debris behind them. These directors indicate that within the commercial community there will remain an indefatigable

⁷⁴ See ante Chapters 2, 3 & 4.

urge for self promotion which is prepared to bend any legal standard in the interests of profit. This proves that the system is imperfect but does not prove that the system is unable to improve or that the law can be a central part of that improvement. No doubt the role of the Serious Fraud Office and the Investigations Department of the DTI will remain sensitive to public scrutiny in making accountable those directors who have intentionally raided corporations for their own benefit casting corporate debris on the society the companies are supporting.

The importance for the law in raising directorial standards is to first recognise its own limitations both legal and cultural respecting not only that the provision has to be used but that there is consensus amongst those it affects that it is desired or at least respected. This is the philosophy underlying the implementation of the non-statutory codes. Yet there is also a requirement for a degree of prescription affording guidance as to the director and providing confidence to all those within the corporate nexus that their interest may not be first but is at least equitably dealt with by the law.

Wrongful trading is at best a backstop which can be utilised in the face of no other alternative but at worst can be viewed as a semantic artefact which filled a legal commitment at a particular time in commercial history. Society wanted the freedom to trade but wanted the legal protection to ensure that everyone with which they traded not only exercised the same degree of skill and care but that they could exercise it and wanted to. This clearly does not reflect the possible reality of the commercial world or of those that trade in it.

The future of governance stands at a vulnerable cross roads as the political climate within the UK becomes increasingly sensitive to the well being of shareholders who now both directly and indirectly form such a substantial part of the electorate. Its future depends on the ability of the legislature to provide a pro active basis which will first define both the role and the legal responsibility of those within the corporate nexus, even if that entails redefining the status of a

particular corporation based on its size and share structure. The implementation of commercial standards will then be able to recognise more clearly, the objective of creating that standard, which in turn reflects the broadening of the corporation's role in society.

In achieving an improved governance structure the metaphysical nature of the concept of governance and of the institutions to which it attaches is paramount. The appropriate regulations must defer to the reasonable capacity of a particular corporation and less to any one particular group in the corporate nexus which it serves. In allowing the corporation to evolve itself in to a more socially based institution as well as a profit making machine, this could be met with approval from those within the corporate nexus who because of the cultural background in which the institution has developed, has regarded internal attrition amongst those in the corporate nexus as being the prerequisite to creating a corporation with both determination and gravitas. This need not be so.